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AUDITING PROBLEMS

A COMPREHENSIVE STUDY IN PRINCIPLES
AND PROCEDURE

By

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PREFACE

"No part of a book," said the late Charles W. Eliot, President-Emeritus of Harvard University, "is so intimate as the preface. Here, after the long labor of the work is over, the author descends from his platform, and speaks with his reader as man to man, disclosing his hopes and fears, seeking sympathy for his difficulties, offering defense or defiance, according to his temper, against the criticisms which he anticipates." During the past eight years I have searched for instances which seemed to me to illustrate fundamental principles and practices in auditing and in accounting investigations, have written these instances up as cases, taught them in classes, and rewritten or discarded them, until after so long a time there have remained the cases which comprise this book.

The teaching of auditing and other business subjects by the case method has resulted largely from the desire of instructors and school administrators to present in the classroom a larger sense of the actuality of things; in turn this presumably has meant greater orientation for the student in the field of his interest. Auditing, like other business and professional subjects, cannot be learned wholly in the classroom; at the same time, experienced teachers are generally of the opinion that a great deal can be learned about these subjects in the classroom—the degree of learning will depend partly upon the abilities of the teacher and student, but also partly upon the nature of the materials which are used in the teaching process.

It is probable that no instructor will ever arrive at a perfect solution of this problem; I sometimes feel, after nearly eight years of teaching auditing with the use of cases—two years in professional training classes in a large accounting organization, three years with graduate students in the Harvard Graduate School of Business Administration, and nearly three years with senior and graduate students in Stanford University—that I am far from a complete answer to the problem. I have, however,

had the satisfaction of seeing students go out from these courses and into public practice and almost universally making good. Perhaps, after all, that is the real test.

The cases included in this book are based upon actual business situations, and each has as its aim the presentation of a real story in such a way that general truths may be drawn from it. Generally the type of business is given as it existed; its name and location are usually changed, and the actual accounting situation is reproduced as nearly as possible. In the case of the figures shown they have been scaled so that the proportions are kept as they were in the business considered; in scaling the figures care has also been taken not to change them so greatly that the business is taken entirely out of the class, from the standpoint of size, to which it rightly belongs.

Three groups or classes of problems comprise the materials in this text; these groups may be described as follows:

I. Problems in which the facts are stated, and it is left entirely for the student to work out the solution. This is typical of the kind of problems which have been used for years in accounting courses, except in so far as the problems comprising this book may more truly represent actual situations and the figures and facts be correspondingly drawn from business life.

II. Problems or cases in which the facts are stated, and, in addition the solution actually made by those who had the problem to solve is given; the solution or procedure set forth, however, either is not correct or is not in accord with the best recognized practice, and the student is confronted with the task of pointing out wherein the solution given is incorrect. This automatically means that the correct solution or procedure is expected of the student.

III. Problems or cases in which the facts are stated, and the solution or procedure is correct and in accordance with the best recognized practice. This sort of case I have commonly designated as a "procedure case," for frequently its greatest value lies in revealing to the student how such matters are actually handled by "giants" in the profession. Here the student is again expected to analyze the situation and to state why he does or does not agree with the principles and procedures as outlined.

These groups, it has seemed to me, give the maximum in men-

tal training and in the development of sound principles as regards the subject of auditing. This is the primary purpose of the case method; in this respect it has not altered the older aims of teaching, but it has enriched our teaching by bringing into the classroom a greater air of reality—a contact with the actual forces of business which so many times has been largely or entirely lacking.

In my own teaching I have made a further classification of the materials used. First, there are cases which the student must actually solve or work out on paper—for example, he must prepare a balance sheet, or a statement of resources provided and expended, or a cash reconciliation, or he must write a report or a certificate. Secondly, there are discussion cases—problems which ordinarily do not require any writing on the part of the student, but which serve as a basis for class discussion; some of these cases may be written or not, at the wish of the instructor.

I believe that it may be said that those who have used the case method consistently have come to feel that sound principles may better be taught by it than by the lecture method, or class-discussion method, or any other method which has been used. Of course, the case is very rarely the sole teaching instrument; it, in combination with the textbook assignment, the lecture, and the recitation-discussion, makes for the ideal teaching device. In the course in auditing I have given approximately one-third of the time to lectures and text-discussions; there are always certain matters which can be covered so much more quickly by the lecture or discussion that cases are not advantageous and accordingly not used. But the bulk of the material is presented by means of cases; through these the basic, fundamental principles underlying auditing are developed. Because the cases relate to some specific instance, the principles presented through them more readily become a part of the student's thought-life; even more important, he more easily applies these principles to other and similar problems in business and industry. The student has not only learned a principle, but he has seen how that principle may be applied to a specific instance; he has learned two things instead of one. To furnish the student the needed background, references are given to pertinent discussions in various standard accounting and auditing texts, and to other recognized sources of accounting information; these references are presented in the Appendix.

But while this volume is intended primarily for the student, it must not be thought of as having no interest for the practitioner. During recent years I have examined several hundred accounting reports, representing the work of nearly forty different firms of accountants, and from these I have chosen the two which seem best to represent what should be included in an audit report; they are the work of two different firms, and are worthy of the study of any accountant who desires the best in audit reports. Similarly, the questionnaire on internal check, leading court cases affecting the auditor, and various cases setting forth actual procedures adopted by leading accounting firms will be of interest and value to the professional practitioner, as well as furnish materials for the student eager to become a professional accountant.

Finally, I come to the most pleasant feature in the preparation of this volume, that of acknowledging the indebtedness I owe to my many friends and professional acquaintances for assistance given me in its preparation. To Dean Wallace B. Donham undoubtedly belongs the chief credit for the development of the case method to its present status in the teaching of business; to him I owe much of the incentive which led to the collection and arrangement of the materials comprising this book. Certain cases were obtained for me by the Harvard Bureau of Business Research, and I express my sincere thanks for these valued materials.

More than two-thirds of the materials included herein were obtained from the files of Price, Waterhouse & Co. The firm has given me access to materials at its offices throughout the country, and from these I have chosen at will those which seemed to me to represent typical situations—neither so difficult that only experienced and mature accountants would fathom them, nor so simple that little educational value would result from them. I have no desire to turn out junior accountants qualified only in the routine mechanics of auditing; on the other hand, problems have been chosen which do familiarize the student with fundamental auditing processes, and which give him an insight into the real professional aspects of the subject. Out of the rich reservoir of materials thus available, only a few problems could be chosen; I regret that so little can be included within the covers of a single volume.

But the assistance of the firm did not stop merely with giving me access to these materials; members of the firm have read many of the cases, and have without ceasing made suggestions as to where satisfactory materials on many subjects might be found. To several members of the staff similar acknowledgments are also due; I especially wish to thank Mr. Frank W. Thornton, of the New York staff, for much valuable assistance. Any acknowledgments which I may make very inadequately measure my indebtedness to this firm.

Likewise, valuable materials have been furnished me by Mr. Arthur E. Andersen, of Arthur Andersen & Co., Chicago, and by Mr. John R. Wildman, of Haskins & Sells, New York. To both of these colleagues in accountancy I express my sincere thanks. Special acknowledgment should also be made to the American Institute of Accountants and to various corporations who have permitted the use of materials comprising portions or all of various problems: although the majority of these concerns must remain incognito, sincere thanks and appreciation are hereby expressed.

To Mr. Edward M. Wales, for two years my assistant in auditing at Harvard and now on the staff of Barrow, Wade, Guthrie & Co., Boston, I express my gratitude for assistance in trying out various cases in classes, and, when necessary, in reconstructing them to make them more usable. Lastly, I wish to acknowledge the debt which I owe my present chief, Dean Willard E. Hotchkiss of the Stanford Graduate School of Business, who has been a constant inspiration during the final preparation of this book.

In offering this volume to my colleagues in teaching and in practice, I do so with the realization that it is but a beginning in this type of auditing literature; the responsibility for all shortcomings is solely my own, and I shall appreciate suggestions and criticisms from each and all.

J. HUGH JACKSON

Stanford University, California,
July 29, 1929.

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Part I—The Auditor and His Work

PROBLEM 1

HASKINS & SELLS

Classification of Accountancy Services

Accountancy practice in the United States has grown during the past fifty years "from a theoretical zero to an institution comprising, probably, 25,000 public accountants, and gross earnings estimated at from \$50,000,000 to \$100,000,000."¹ Such growth has necessitated an analysis and study of the services performed by public accountants, their relations with clients and others, the uses to which their reports are put, and a classification, definition, and differentiation of the services rendered. With this in mind the firm of Haskins & Sells has developed, on the basis of 5,000 engagements, a service classification; the classification was then tested over a period of two years on 10,000 additional engagements. This service classification is as follows:²

¹ See *The Accounting Review*, Vol. III, No. 2 (June, 1928), pp. 124-130.

² A similar service classification was submitted in 1926 by the Committee on Education of the American Institute of Accountants to the Council of the Institute, and by it was referred to the Annual Meeting. After discussion it was unanimously resolved (see American Institute of Accountants Year-Book, 1926, p. 94) that "the report be referred to the executive committee with instructions to that committee to circulate the report to the entire membership with a request for the opinions of members as to changes which might be beneficial, and with further instructions to the executive committee after receiving advice from the membership so to arrange the report as in its opinion in the light of such advice would be most advantageous to the profession; that thereafter the executive committee be authorized to issue the report in such amended form to the membership at large and to the general public; and, furthermore, that the amended report, after final action by the executive committee, be referred back to the committee on education with instructions to proceed with the plan that had been outlined." The Committee on Education consisted of John R. Wildman, Chairman, New York; David Himmelblau, Illinois; J. O. McKinsey, Illinois; J. Hugh Jackson, Massachusetts; and G. V. W. Lyman, Louisiana.

In accordance with the above resolution the committee's report was printed and distributed to the membership of the American Institute of Accountants; so far as the author is aware, nothing further has ever come of these recommendations of the Committee on Education. It is to be hoped that some action on this highly important matter will soon be taken by this national body representing accountancy.

Service Classification

1. GENERAL AUDITS³

A general audit comprehends verification of the assets, liabilities, capital, and surplus as of a given date, and of the cash receipts and disbursements, income, expense, and miscellaneous profits and losses for a period ended on that date, together with the preparation of an audit report, with or without a certificate.

This type of service contemplates that the accountant, in addition to verifying balances at a given date, shall satisfy himself reasonably as to the transactions resulting in such balances and as to the accuracy of the records.

³ The Committee on Accounting Terminology of the American Institute of Accountants has developed a somewhat more detailed classification of auditing services as shown by the following definitions appearing in *The Journal of Accountancy* (Vol. XLIV, pp. 448-452) for December, 1927, as follows:

AUDIT:

"An examination of the books of account, vouchers and other records of a public body, institution, corporation, firm, or individual or of any person or persons standing in a fiduciary capacity, for the purpose of ascertaining the accuracy and integrity of the accounting and of certifying thereto upon the statements rendered.

"In the absence of any qualifying expression defining the extent to which it has been limited, an audit is understood to be an examination of the subject matter of the accounting in all its financial aspects, covering, to the extent that these several classifications of accounts may be involved, the verification of assets, liabilities, receipts, disbursements, income, expenditure, capital and reserves and their application; surplus and profits and their disposition, in such detail as may be necessary in the circumstances of each individual case to permit of an unqualified certification of the accuracy of the statements rendered and of the proper accountability of the fiduciary parties.

"In practice an audit is in many cases limited in varying degrees recognized by custom and indicated by qualifying expressions, the definitions of which are given below, as follows:

Balance sheet audit
Cash audit
Partial audit
Special audit

"Audits not necessarily limited in scope are frequently given other designations or descriptions, defined below, as follows:

Complete audit
Continuous audit
Detailed audit
External audit
Internal audit
Private audit
Public audit

"See also:

Examination
Investigation

BALANCE SHEET AUDIT:

"A balance sheet audit consists of the verification, as of a given date, of the assets, liabilities, capital, surplus and of all reserve accounts, including as incidental thereto, such examination of the operations as may be necessary to give credence to the stated financial condition.

"It does not include the detailed vouching of *all* receipts and disbursements or all details of income and expenditure, nor does it establish the accountability of the fiduciary parties, except on broad lines.

"It should be accompanied by a report stating the nature and extent of the verifications which have been made, drawing attention to any items requiring explanation or comment, or by a certificate stating the opinion of the auditor as to the correctness of the statement submitted, or by both report and certificate.

2. CASH AUDITS

A cash audit comprehends verification of all receipts and disbursements for which an accounting should have been made during a period, of the accuracy of the cash records, and of the balance at the end of the period, together with the preparation of a report, with or without a certificate.

3. GENERAL EXAMINATIONS

A general examination covers a period, and consists of verification of assets, liabilities, capital, and an analysis of surplus, as of a given date, an analytical review of income, expenses and miscellaneous profits and losses for a period ended on that date, and the

CASH AUDIT:

"An audit limited to the verification of cash transactions for a stated period, for the purpose of determining that all cash received has been duly brought into account and that all disbursements are properly authorized and vouched.

"A cash audit is detailed in character but limited in scope. It is concerned with the sources of receipts and the nature of disbursements only to the extent necessary to substantiate their accuracy. Such an audit establishes the accountability of the persons charged with responsibility for cash, a certificate to this effect being given on a summary in appropriate form of the cash transactions for the period.

COMPLETE AUDIT:

"One in which the examination extends to a verification of the details of all the books of account including subsidiary records and all supporting vouchers, as to mathematical accuracy, complete accountability and correctness of accounting principle. In modern practice such an examination is seldom made.

CONTINUOUS AUDIT:

"One in which the detail work is performed either continuously or at short regular intervals throughout the fiscal period, usually at the shortest intervals (e.g., weekly or monthly) at which subsidiary records are closed and made available for audit in controllable form. Such 'continuous' work leads up to the completion of the audit upon the closing of the accounting records at the end of the fiscal period. A continuous audit differs from a periodical audit, even though the detail work be performed, for example, monthly, in that no report is made except of irregularities detected and adjustments found to be necessary, until the end of a completed fiscal period, and further, that the certification of balance sheet figures, as such, may be deferred until the fiscal closing. A continuous audit is not necessarily a complete audit, but may be limited in scope according to understanding and as may meet the requirements of the individual case.

AUDIT—DETAILED:

"This is similar to a complete audit, but sometimes a series of tests is substituted for a complete audit of each and every entry.

"In some cases an audit may be detailed and yet limited in scope, e.g., a cash audit.

"The form of report will depend on the scope of the work, but, so far as the work goes, will follow the corresponding portion of a report of a complete audit.

AUDIT—EXTERNAL:

"This term is not in common use, but is occasionally used to indicate an audit by some one, such as a public accountant, external to the concern being audited.

AUDIT—INTERNAL:

"This term refers to an audit made by members of the staff of the concern audited. Frequently 'staff auditors,' 'traveling auditors' or 'inspectors' are employed to make continuous or periodical audits of some or all of the transactions; the scope is not definite, and their work is frequently supplemented by examinations made by public accountants.

PARTIAL AUDIT:

"A term used to describe (a) a special examination of some portion of a set of accounts or records or of all the accounts for an incomplete period, such work being the subject of

preparation of a report containing a balance sheet and a statement of income and profit and loss, with or without a certificate.

A general examination is distinguished from a general audit by omission to verify the cash receipts and disbursements and by verifying the operating accounts through analytical study and investigation rather than by a general audit of the transactions. It is distinguished from an examination of financial condition, in the more extensive review of the operations as such, rather than as an incident to the verification of assets and liabilities.

The object of this service is to determine that there is no overstatement of net assets, or of net profits; not to determine fiduciary integrity. While, because of somewhat extensive consideration of

specific instructions describing and limiting its extent; or (b), more inexactly, a test of the detailed transactions made in conjunction with a balance sheet audit.

AUDIT—PRIVATE:

"The use of these terms is confined to British practice and is defined by Pixley as follows:

"Private audits may be divided into two classes: (1) where the auditor is instructed by his client to perform certain specified auditing duties which, when he has discharged them in accordance with such instructions, terminates such duties and at the same time his responsibilities; (2) where he is instructed by one or more individuals, who may be interested in some business or estate, which although not registered under any act of parliament, is nevertheless subject to some agreement or deed, or testamentary document, and perhaps also subject to some act or acts of parliament and subsequent legal decisions.' *Pixley's Accountants' Dictionary*, p. 54.

AUDIT—PUBLIC:

"Public audits are those which are carried out under the provisions of an act or acts of parliament, or under the clauses of a royal charter. In such cases the auditors are appointed in accordance with the provisions of the act of parliament or of the royal charter combined with special regulations or by-laws made in conformity therewith, and although these duties are not actually defined, the forms of the accounts which they have to certify, either with or without qualification, are frequently prescribed.' *Accountants' Dictionary*, p. 54.

SPECIAL AUDIT:

"An audit made for any purpose other than the verification or certification of statements of account presented according to regular procedure at the close of an accounting or fiscal period. Such an examination may be one where specially exhaustive attention is given to detail, or it may, on the other hand, be a sketchy examination of some limited feature of the accounts. An interim or periodical audit made in the regular course, however, is not a special audit.

EXAMINATION:

"Without some qualifying term this word has no definite accounting meaning beyond that given by the dictionary. It is used in accounting in conjunction with a statement of what has been examined.

INVESTIGATION:

"An investigation, in the accounting sense, is a special examination of books and records, in the course of which the auditor selects and follows any lines of inquiry that seem to him most useful in obtaining the specific information that is the object of the investigation. As a rule some parts of the audit are stressed and some passed more lightly; and reference may be made to records and books other than those that are being investigated. The programme of work lies largely in the auditor's discretion and is varied during the course of the work whenever matters are found needing inquiry.

"An examination made for the purpose of financing, frequently covering accounts extending over a period of years which may or may not have been previously audited, is commonly referred to as an investigation.

INVESTIGATION—SPECIAL:

"The proper use of the word 'investigation' in connection with accountancy implies some particular object to be gained, or particular result stated, and indicates something different from an audit; hence it is seldom, if ever, necessary to qualify it by the addition of 'special' or any similar expression."

the operating accounts, there is more opportunity than in an examination of financial condition of detecting any existing internal fraud, the service may not be relied upon in that respect.

Any restriction upon the verification of one or two balance sheet items only, such as inventories and accounts receivable, while calling for qualification of such items, does not remove the engagement from the class of general examinations.

When arising in connection with the proposed issuance of securities, mergers, consolidations, or purchases and sales of companies and properties, this type of engagement, in order to satisfy the requirements of financial agencies involved, as to condition, earning power and management, calls for a report in which particular attention is given to classification in statements and to appropriate information in the comments. The report contains, frequently, a balance sheet giving effect to the proposed financing.

While a general examination usually covers both financial condition and operations, occasionally it may be confined to such verification of income, expenses, miscellaneous profits and losses, and related balance sheet accounts, as may be necessary to determine that there has been no overstatement of net profits. In a report on an examination of this character, the statement of income and profit and loss may be certified, but a balance sheet, if submitted, should be shown as having been prepared from the books without verification.

4. EXAMINATIONS OF FINANCIAL CONDITION

An examination of financial condition comprehends verification as of a given date of the assets, liabilities, and capital, and an analysis of surplus, including as an incident thereto, such examination of the operations as may be necessary to give credence to the stated financial condition, and the preparation of a report containing a balance sheet which may or may not be certified. If a statement of income and profit and loss is included in the report, it should be qualified as having been prepared from the books without verification.

This type of service, while contemplating certain examination of the records with a view to substantiating the assets as represented and affording reasonable assurance that there are no liabilities (actual or contingent) other than those admitted, does not comprehend systematic verification of transactions, such as is required in a general audit, and therefore may not be relied upon to disclose any understatement of assets which may have been concealed in the operating accounts.

Restriction in the verification of one or two balance sheet items

only, such as inventories and accounts receivable, notwithstanding the fact that such restriction calls for qualification, does not constitute sufficient reason for excluding the engagement from this class of service.

5. LIMITED EXAMINATIONS

A limited examination may involve either partial or complete verification of certain assets and liabilities, or of certain operating transactions, and the preparation of financial statements from the books without further verification. This type of engagement demands a report (without certificate and without comments, except such as are embodied in the presentation) in which the service is referred to in the opening paragraph of the presentation as a limited examination, and assertion is made therein to the effect that, in accordance with the instructions, only certain account balances according to the records have been verified. The presentation also must set forth that the statements are not certified, and must explain as to each item the scope and results of the verification. The statements must be so marked under the descriptive heading, as clearly to show that they were prepared from the books with only such verification as is indicated opposite the respective items; each item must be marked to indicate whether or not it was verified, and if partially verified, such fact must be indicated, together with reference to the presentation which will show the scope and results of the verification; and there must be a footnote to each statement to the effect that the statement must be considered in the light of the accompanying comments.

When the service is restricted to one account, the verification of which is complete and satisfactory, a report containing a statement confined to that account may be certified without qualification.

6. INVESTIGATIONS

An investigation contemplates inquiry into financial, industrial, or other activities or phases, or financial involvements, according to the records, rather than a general review of audit of the accounts, together with the preparation of a report.

7. PREPARATION OF STATEMENTS FROM BOOKS OR RECORDS WITHOUT VERIFICATION

Statements prepared from the books or records without verification necessitate the use of unwater-marked paper, bound (if at all) in a plain back, without any indication, in the statements them-

selves, or in anything attached to the statements, that they were prepared by certified public accountants.

In cases where it is necessary to include in a report containing statements which have been verified, any statements which have been prepared from the face of the books without verification, or with only partial verification, such statements must be so marked, under the descriptive heading and at the bottom, as clearly to indicate that they were prepared from the books without verification, or with only such verification as is indicated opposite the respective items, depending on the situation.

8. TAX ENGAGEMENTS

A tax engagement may consist of: preparing or reviewing tax returns, (a) from records which have been audited, (b) from records which have not been audited; contesting assessments or prosecuting tax claims; preparing and rendering opinions on tax matters.

9. GENERAL ACCOUNTING SYSTEMS

An engagement for general accounting system work may consist of: conducting surveys; devising and installing systems of account and of record.

10. COST SYSTEMS

A cost system engagement may consist of: conducting surveys; devising and installing cost finding systems.

11. BUDGETS

A budget engagement may consist of: conducting surveys; preparing and installing budget systems.

12. BOOKKEEPING AND ACCOUNTING ENGAGEMENTS

An engagement to do bookkeeping and accounting work may consist of: preparing and recording bookkeeping entries; acting as bookkeeper, auditor, or comptroller, etc.

13. OPINIONS

This class of engagement consists of preparing and rendering opinions having to do with accounting and financial matters.

14. MISCELLANEOUS

This class includes all engagements not comprehended in the foregoing, such as acting as liquidating trustee, acting as arbitrator in

accounting controversies, acting as umpire in accounting disputes, giving testimony in court, rendering advice in accounting matters, interpreting financial data, instructing bookkeepers, checking statements, etc.

Discuss critically these classifications of accountancy services, and comment upon the completeness of each.⁴

PROBLEM 2

CRAIG V. ANYON

Legal Duties and Liabilities of Professional Auditors

During the years 1913 to 1917, inclusive, a large firm of professional accountants, of which Mr. Anyon was a member, had audited the books of a New York brokerage firm, of which Mr. Craig was a member. An audit was made and a report submitted every three months. For the entire period during which the audits were done, the accounting firm was paid \$2,000 for its services. By reason of extraordinary confidence placed in one of its employees by the brokerage firm, and contrary to the advice of the accounting firm, said employee had been able to defraud his firm of \$1,177,805.26. The falsification of the books had not been disclosed by any of the audits, but, as a result of an investigation made by the brokerage firm, the guilty party confessed to his wrong-doing. An action for damages was brought by the brokerage firm against the accounting firm; the court held that the accountants were guilty of negligence and that the brokerage firm might recover the \$2,000 paid as compensation, and that the defalcations of the employee of the brokerage firm were criminal acts which were not the proximate result of the negligence of the accountants, but resulted from the negligence of the brokerage firm to supervise properly the acts of its employee.¹ The case, as decided on February 20, 1925, is as follows:

⁴ See also Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 4-6, 60-66; Jackson, *Audit Working Papers*, pp. 7-9, 35-37; Federal Reserve Board, "Verification of Financial Statements," par. 1; Kohler and Pettingill, *Principles of Auditing*, pp. 17-22.

¹ In *East Grand Forks v. Steele* (121 Minn. 296; 45 L.R.A. [N.S.] 205; 141 N. W. 181; Ann. Cas. 1914 C, 720) a municipality endeavored to recover from public accountants the

CRAIG ET AL. V. ANYON ET AL.²

(Supreme Court, Appellate Division, First Department, February 20, 1925.)

Appeal from Supreme Court, New York County.

Action by William R. Craig and others against James T. Anyon and others. From a judgment against defendant James T. Anyon and others for \$2,371.61, in so far as it limits plaintiff's recovery to \$2,000, and from an order, made on motion to set aside the verdict of the jury, in so far as the order sets aside part of verdict to the effect that damages to plaintiffs, resulting directly and proximately from negligence of such defendants in the performance of agreement with plaintiffs, amounted to \$1,177,805.26, plaintiffs appeal. From such judgment, in so far as it permits plaintiffs to recover \$2,000 and costs, and from such order, in so far as it denies defendants' motion to set aside that part of the verdict finding that these defendants were negligent in the performance of the agreement, defendant James T. Anyon and others appeal. Judgment and order affirmed.

Argued before CLARKE, P. J., and MERRELL, FINCH, and MARTIN, JJ.

Moore, Hall, Swan & Cunningham, of New York City (John H. Jackson, of New York City, of counsel, and Warren W. Cunningham, of New York City, on the brief), for plaintiffs-appellants-respondents.

Cook, Nathan & Lehman, of New York City (Alfred A. Cook, of New York City, of counsel, and Harold Nathan, Frederick F. Greenman and Nathan R. Margold, all of New York City, on the brief), for defendants-respondents-appellants.

amount of its loss through a defalcation which the audit did not disclose; the court's opinion, in part, was as follows:

"Defendants represented themselves as expert accountants, which implied that they were skilled in that class of work. In accepting employment as expert accountants, they undertook, and the plaintiff had the right to expect, that in the performance of their duties they would exercise the average ability and skill of those engaged in that branch of skilled labor. They were employed to ascertain, among other things, whether any irregularities had occurred in the financial transactions of the city clerk, and, if so, the nature and extent of such irregularities. If, from want of proper skill, or from negligence, they did not disclose the true situation, they failed to perform the duty which they had assumed, and failed to earn the compensation which plaintiff had agreed to pay them for the proper performance of such duty. The work of an expert accountant is of such technical character and requires such peculiar skill that the ordinary person cannot be expected to know whether he performs his duties properly or otherwise, but must rely upon his report as to the thoroughness and accuracy of his work. . . . The City is entitled to recover back the amounts paid, upon proving that, through the incompetence or the negligence of defendants, the report was in substance misleading and false. . . . The damages claimed on account of the losses resulting from the defalcations of the clerk and the insolvency of his surety are too remote to be recovered, without showing the existence of special circumstances, known to defendants, from which they ought to have known that such losses were likely to result from a failure to disclose the true condition of affairs."

² 208 N.Y.S. 259.

MARTIN, J. The plaintiffs, during the years 1913 to 1917, inclusive, were engaged in business in New York City as brokers in stocks and commodities, such as cotton, wheat, and coffee. Their transactions on behalf of customers were conducted on the New York Stock Exchange, the Cotton Exchanges in New York and New Orleans, the Chicago Board of Trade, and similar exchanges in which they had membership. The business was apparently prosperous and the partners had enjoyed a large income therefrom. On May 26, 1927, through the confession of Robert Moore, an employee of their commodities department, following an office investigation, they learned that their prosperity had been an illusion, and that their books had been falsified by Moore throughout a period of nearly five years, during which they had been defrauded of over \$1,250,000.

During the entire five-year period, the defendants, composing an accounting firm well known both in the United States and England, were under retainer from the plaintiffs. Each three months throughout this period the books were audited by them and a report submitted, by which report the plaintiffs say they were assured the books were properly kept; no reference being made to any irregularity. The action is founded upon the charge that these audits were negligently made; that, had any audit been made with reasonable care, the falsification of the books would have been discovered, Moore would have been discharged, and no further loss would have occurred.

The complaint alleges a contract whereby the defendants undertook periodically to audit the plaintiffs' books and accounts and to report any errors or omissions therein, and negligence by the defendants in the performance of the contract, and damage to the plaintiffs amounting to the sum of \$1,280,233.61. This is made up of sums paid to customers to whom, it is alleged, nothing would have been paid, except for the defendants' negligent failure to report that similar unauthorized payments had previously been made, and of other sums paid to brokers, and not charged to any customer, upon transactions which, as it is alleged, would not have been permitted, were it not for the defendants' negligence in failing to report irregularities, consisting of similar transactions previously made.

The answer admits the employment of the defendants to audit the plaintiffs' books, "subject to certain instructions and limitations imposed" by the plaintiffs and their predecessor firms, denies the allegation of negligent performance of the contract, and sets up as a defense negligence on the part of the plaintiffs, and both negligence

and "larceny, embezzlement, and criminal acts and practices" on the part of employees of the plaintiffs.

The action was tried in May, 1922. At the end of plaintiffs' case a motion to dismiss was denied, except as to six defendants, who had become members of the firm after 1917. The defense rested without offering evidence, and the motion to dismiss was renewed. The court reserved decision in accordance with the practice set forth in section 1187 of the Code of Civil Procedure (sections 459, 585, Civil Practice Act) and submitted two specific questions to the jury, as follows:

"Were the defendants negligent in the performance of their agreement with Craig & Co.?"

"If so, what damages to the plaintiffs resulted directly and proximately from such negligence?"

The court charged that, if the defendants were found liable, the verdict must be either for \$2,000, the amount paid as compensation for the defendants' services, or for \$1,177,805.26, the amount of plaintiffs' actual loss as proved. To the first question the jury answered, "Yes;" to the second question, "\$1,177,805.26."

Upon the rendition of the verdict the defendants' motion to set aside the answer to the second question was granted, the defendants' motion to set aside the answer to the first question was denied, and a general verdict was directed in favor of the plaintiffs for \$2,000; appropriate exceptions being noted by the plaintiffs. The order recites that the court proceeded "on the ground that as a matter of law the only loss which resulted directly and proximately from negligence of the defendants was the sum of \$2,000."

The three main questions litigated were: (1) the degree of care actually used by the defendants; (2) the understanding or agreement of the parties with respect to the scope of the audits to be made; (3) the degree of care used by the plaintiffs. The three questions are closely interlocked, and are to be answered by the inferences to be drawn from practically undisputed evidence. It is apparent from an examination of the record that the jury found the defendants were negligent and the court agreed with the jury on that question, but disagreed with it as to the damages resulting from such negligence.

Three questions are before us on this appeal: (1) Were the defendants negligent? (2) Did the plaintiffs' negligence contribute to the loss? And (3) assuming defendants were negligent, what damages resulted therefrom? The first question has been resolved in favor of the plaintiffs, both by the jury and the court. With

reference to that question, therefore, it is necessary only to inquire whether the evidence warranted a finding of negligence.

[1] The plaintiffs contend that defendants are chargeable with negligence by reason of the carelessly conducted audit of the plaintiffs' books. It is asserted that one or more books were in the custody of the plaintiffs when each audit was made, an examination of which would have disclosed the account of one Zabriskie as reflecting an indebtedness to the plaintiffs of many thousands of dollars. The defendants offered no evidence and no defense, except the cross-examination, which developed the fact that an inspection of all the books in the office would have disclosed irregularities; whereas, the auditors, in making investigations and reports, relied on books, papers, and carbon copies of statements to customers furnished by one Moore, who apparently had charge of a division of the business.

There can be very little doubt as to carelessness by the auditors. Whether it caused the loss is a more difficult question. Although a proper audit would have disclosed facts leading to the discovery of Moore's wrong-doing, there are a number of other elements entering into this case, which show that the plaintiffs are not without blame and might have avoided the loss. They now seek to make Moore a mere clerk. He was much more. He was in charge of plaintiffs' commodities department. He was permitted absolutely to control that department, and the real cause of the loss is to be found in the fact that he was given a free hand, without any supervision, to deal with the accounts of Zabriskie and others at will. He decided what entries were to be made by the bookkeepers, and how they were to be made, so far as transactions in his division of the business were concerned. He was permitted to give directions for the firm to outside brokers as to whether transactions should be closed or carried as "open."

This appears to have been of great assistance in enabling him to keep the actual condition of the Zabriskie account concealed. To this customer large sums of money were paid from time to time, the payment of which was unwarranted; for the accounts with him would have shown the absence of a sufficient balance to meet margins. Money was paid to him at a time when he must have been heavily indebted to plaintiffs. Should the plaintiffs have relied on Moore, who was dealing with the Zabriskie account for Zabriskie and at the same time taking care of the account for the plaintiffs? Certainly they were called upon to exercise some supervision in the matter. Having left a branch of their business to an employee, it does not seem reasonable that, although there was no supervision,

they should now be permitted to charge the loss to the auditors, who, apparently on account of the dishonesty of such employee, failed to uncover defalcations. In his charge to the jury the court said:

"These defendants rendered such reports every three months. These reports undoubtedly contained mistakes and inaccuracies. They were based on what Moore wanted them to believe was the position of the firm, and not on the true position of the firm."

The auditors relied on Moore. They were deceived by him. So were the plaintiffs. The auditors could have performed their work independently of what they were told by Moore. But Moore was the employee who dealt with them, and who gave them the books and papers upon which they were to work. They did not suspect any wrong-doing, and believed they were justified in taking the information given them by the firm's representative, who exercised, without interference, power to deal with them in reference to their work in the commodities department. Defendants relied on Moore's honesty, but no more than did plaintiffs.

In *Re Kingston Cotton Mill Co.*, (No. 2) [1896] 2 Ch. Div. 279, Lord Justice Lindley said:

" . . . In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by every one who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason: The stock journal showed the quantities—that is, the weight in pounds—of the cotton and yarn at the end of each year. Other books showed the quantities of cotton bought during the year and the quantities of yarn sold during the year. If these books had been compared by the auditors, they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shown in the stock journal, and so much less that the value of the cotton and yarn entered in the stock journal could not be right, or at all events was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But, although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's return? I cannot bring myself to think they were, nor do I think that any jury of business

men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier, who has to account for the cash which he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry. The auditor's duty is not so onerous as the learned judge has held it to be."

Lord Justice Lopes said at page 290:

"The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than in *In re London & General Bank*, [1895] 2 Ch. 673. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance sheet certified by the auditors and presented to the shareholders. This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

Lord Justice Kay said at page 293:

"It is said that it is easy to be wise after the event. In former years, when the stock journal was correctly entered, the alterations in value in a year were frequently very considerable. The increase in the years now in question did not excite any suspicion in the directors. Why should it in the auditors? They had no reason to distrust the manager. Moreover, he had, or was supposed to have, taken the stock which was actually on the premises at the date to which the balance sheets referred. The auditors could not do this. The only book from which they could obtain information as to the quantities

received in the year other than the stock journal was a book called the 'invoice guard book,' in which were pasted the invoices received with goods supplied. But this was not necessarily accurate. Invoices received might have been omitted. Goods might in some cases have been received without invoices. Were the auditors bound to enter upon an investigation which could not bring out an accurate result in order to test the truth of a statement by the manager which no one had any reason to discredit?"

The court instructed the jury that these auditors did not guarantee the correctness of their accounts:

"They do not say to the public: 'Let us examine your books and vouchers, and we will with absolute certainty discover any dishonesty, every mistake, that exists in those books, and we will protect you against that.'"

That is not what they undertook to do. They agreed to use such skill in the performance of their agreement as reasonably prudent, skilful accountants would use under the circumstances.

One of the plaintiffs, Mr. Craig, said that, when defendants originally began their duties for a predecessor firm, they agreed to supervise, superintend, and send out certain statements to customers. Mr. Craig knew that was never done. Plaintiffs refused to allow statements to be sent to customers. It is further asserted that the defendants agreed to take the open contracts and to calculate the actual liability of the customers thereon at the time of each audit. It was known that defendants never made such calculations. The plaintiff, Craig, says that they told him:

"We have to make that calculation both for straddles and open accounts before we can tell you what is the actual standing of this firm."

Craig's statements with reference to the contract were made to a man who has since died, leaving no way of directly meeting his testimony in this respect. Craig was aware that there had been for several years a failure to live up strictly to arrangements and agreements as to what was to be accomplished.

Zabriskie started his account in 1909, writing the brokers a letter that he was sending them \$200 for margin, and that Moore, the plaintiffs' employee, should have the right to give directions to buy and sell for his account. In other words, it became what is known as a discretionary account. He directed that, as soon as the \$200 margin was exhausted, the account should be closed. Moore thereafter gave orders to buy and sell for Zabriskie's account. The relationship between Moore and Zabriskie does not appear, but it does appear that

the loss could not have occurred if Zabriskie's account had been closed out when his margin had become exhausted.

When Moore gave an order to a broker in Chicago to sell wheat, he would sometimes charge that order to the account of Zabriskie, but at other times he would not. He always entered the transactions, or had them entered, in the blotter. He told the clerks what entries they were to make in the charge ledger. At times he gave an order to enter such contracts against Zabriskie in this ledger, and at other times he did not. If these books were all examined at the end of the three months, any accountant, skilled or unskilled, would have discovered something was wrong, or that some entry remained to be made. Items not entered in the proper place were entered in the back of the book; on pages beyond the charge account in the customers' open contract ledger. They were made against Zabriskie, but with instructions that they were not to be entered as actual charges against him. This was feasible because Moore was allowed to deal to the extent of very great sums in Zabriskie's account for Zabriskie, and at the same time had charge of the branch office to the extent of deciding what bookkeeping entries should be made. Though Moore was directing these very extensive dealings from both sides, nothing was ever done to check up and see whether the transactions were in order.

Moore arranged for payments to Zabriskie from time to time. These payments should never have been made; for, with the true condition of his account known, it would have been apparent that margins on hand did not warrant them. Had the "opens" been properly checked, it could have been seen whether Zabriskie had balances due him and whether they warranted the payments made to him. Craig made large payments to him without attempting to ascertain how his accounts stood. Moore had the sole control in a department of plaintiffs' activities, and therein plaintiffs allowed him to represent their interests, as well as the interests of some of those dealing with them. He was permitted to represent conflicting interests. This was true when the accountants were there and when they were not. During the whole of the three-months' period between audits, being a major part of the time, the plaintiffs paid out large sums of money without any investigation or examination of the books, though an examination would have disclosed the irregularities for which they now attempt to hold the defendants.

The actual liability of Mr. Zabriskie on open transactions and the amount to be paid out should have been ascertainable from the customers' ledger. The evidence shows that between February 28, 1917,

and May 26, 1917, there was an actual change of position of something like \$500,000. Were plaintiffs justified in relying, as reasonably prudent business men, on Moore's honesty, though he was allowed to exercise discretionary powers on behalf of customers? Moore was trusted with supervision over the department where the loss occurred, and at the same time was permitted to deal at will for Zabriskie. He was left in the same position as to at least one other account. He was also margin clerk. As such it was for him to decide what margins should be maintained.

His various and diverse duties and powers put him in a position to keep records and papers, or cause them to be kept, so as to deceive the accountants who relied on him. If it be assumed that they should not have done so, it is nevertheless true that the plaintiffs also relied upon them to an extent beyond all reason in view of all the circumstances. They were guilty of the same kind of negligence of which they now complain. It may be true that a proper accounting would have put the plaintiffs on guard with reference to Moore's wrong-doing, but it is also true that, if the plaintiffs had attended to their business and, in view of the large transactions involved, had looked up Zabriskie's account when payments were being made to him, the dishonesty of Moore would have been discovered.

The plaintiffs admit that they never inquired into the "opens" of Zabriskie when he asked for money, nor when he placed orders to be executed. Had they done so, nothing would have been paid to him, other than as his margins warranted, and losing trades would have resulted in his account being closed. Instead, they left these matters to an employee, who, though not a partner or principal, had full authority in his department.

It also appears that the accountants notified the plaintiffs in writing that a certain ledger should not be taken out of the control of one Hodge, and that, if it took up too much of his time, an assistant should be engaged under his control. The accountants wrote the plaintiffs "as this ledger is now operated, it is practically a check on the subsidiary department, and we see no advantage in establishing a separate ledger." Notwithstanding this advice, one of the partners put that ledger under Moore's direction, leaving him with control of every book in the office necessary to work his schemes and at the same time conceal his misdeeds.

Craig had knowledge that Moore was to have discretion as to Zabriskie's account. This is shown by a letter:

"I inclose herewith check for \$200, which please place to the credit of my account. I am not fully acquainted with the method of

trading in cotton, and wish to leave the operation of my account entirely in Mr. Moore's hands, with instructions to close out if the margin becomes exhausted."

It seems to us, therefore, that the loss was due to the failure of Moore to close out the account when the margin became insufficient. No matter what the accountants had reported, if Zabriskie's account had been closed, there would have been no loss. True, it was not closed out because of the wrong-doing of Moore; but slight supervision would have disclosed Moore's wrong-doing.

Counsel for plaintiffs in his opening stated:

"Moore got a man by the name of Zabriskie—we do not know Zabriskie, except as a name on the books and as a witness in litigation that grew out of these transactions—since Zabriskie wrote a letter to the plaintiff firm as then constituted, and you will understand me, of course, when I say plaintiff firm, I mean Craig's firm, in which he inclosed a check for \$200, which he said he wanted to trade in commodities, \$200 will constitute a margin, that Moore was to do the trading for him, and that, if the margin of \$200 was exhausted, that was the end of the transaction."

Zabriskie was in fact better known to the plaintiffs than they would admit. Craig knew Zabriskie for about 10 years, having spoken to him a number of times. In 1910 he took Zabriskie to a dinner of the Stock Exchange members, to which he invited all of his best customers. Craig raised Moore's salary because Zabriskie, a valuable customer, desired it and said he could obtain for Moore better compensation elsewhere.

Moreover, the Zabriskie account was the most active the plaintiffs carried. He did from 75 per cent to 85 per cent of their Chicago commodities business. Notwithstanding the tremendous loss which such an active account might bring to the plaintiffs, they never investigated the financial standing of Zabriskie; they never received a mercantile report on him; they never asked him for references, in the face of the fact that his initial margin was but \$200. During this period, the plaintiffs paid Zabriskie \$123,689.04 without once making an examination of the books to see whether anything was due him. We are of the opinion that the loss was not entirely the result of the negligence of the defendants, but also resulted from the careless and negligent manner in which the plaintiffs conducted their business.

The verdict embraces two items: Money paid to Zabriskie, and subsequent losses to his account which he failed to meet. These losses were paid to other brokers by Moore. They would not have been incurred, if Zabriskie's account had been investigated. The purchases

to which they relate would not have been made, for there was no margin in Zabriskie's account to make them. Before a payment was made to Zabriskie or an order given by or for him was executed, the "opens" and the sufficiency of his margin should have been investigated. This should have been done from day to day, at times from hour to hour, even though plaintiffs had audits from the accountants.

In *Deyo v. Hudson*, 225 N. Y. 602, at page 615, 122 N. E. 635, 639, the court said:

" . . . If they had no right to rely exclusively upon the assurance of Mitchell, when they might have prevented the loss themselves, they cannot recover."

There is no doubt in this case that plaintiffs could have prevented the loss by the exercise of reasonable care, and that they should not have relied exclusively on the accountants.

[2] We think the damages cannot be said to flow naturally and directly from defendants' negligence or breach of contract. Plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care. In *City of East Grand Forks v. Steel*, 121 Minn. 296, at pages 298-300, 141 N. W. 181, 182 (45 L. R. A. [N.S.] 205, Ann. Cas. 1914C, 720), the court said:

"This is not an action in tort, but an action to recover damages for breach of contract. As said by Justice Mitchell, in *Whittaker v. Collins*, 34 Minn. 299, 25 N. W. 632, 57 Am. Rep. 55 (an action brought to recover for the negligence of a physician): 'Where the action is not maintainable without pleading and proving the contract, where the gist of the action is the breach of the contract, either by malfeasance or nonfeasance, it is in substance, whatever may be the form of the pleading, an action on the contract. . . . The foundation of the action is the contract, and the gravamen of it its breach.' The rule governing liability for breach of contract is given in the syllabus to *Sargent v. Mason*, 101 Minn. 319, 112 N. W. 255, as follows: 'In an action for damages for breach of contract, the defaulting party is liable only for the direct consequences of the breach, such as usually occur from the infraction of like contracts, and within the contemplation of the parties when the contract was entered into as likely to result from its nonperformance.' . . . The damages claimed on account of the losses resulting from the defalcations of the clerk and the insolvency of his surety are too remote to be recovered, without showing the existence of special circumstances, known to defendants, from which they ought to have known that such losses were likely to result from a failure to disclose the true condi-

tion of affairs. Such losses are neither the natural nor the proximate consequences of the failure of defendants to make a proper audit. Neither are any facts shown from which it may be inferred that a loss from either of these causes was or ought to have been contemplated, when the contract was made, as likely to result from a breach of duty on the part of defendants."

In *Saugerties Bank v. Delaware & Hudson Co.*, 236 N. Y. 425, at page 430, 141 N. E. 904, 905, the court said:

"As I say, this criminal act made it possible to use them; without it they could not have been used, and the defendant's omission would have resulted in no harm. Under these circumstances I fail to see how it can be said that its omission was the proximate cause of plaintiff's injury. In the first place, it has been found as matter of fact that it was not such proximate cause, and ordinarily it is to be determined as a question of fact whether there has been such a connection between cause and effect as to make the former proximate. *Milwaukee & St. Paul Ry. Co. v. Kellogg*, 94 U. S. 469, 475. But, if we disregard this particular finding of fact, we then have it on other findings that between defendant's omission and plaintiff's injury there has intervened the criminal act of a third party, without which the injury could not have occurred. There has been produced a great amount of legal literature and numberless opinions on this subject of proximate cause, which it is impossible and undesirable to attempt to review. But I think that there is one fundamental rule which has been clearly established in the discussion of the subject, which is decisive of this case, and that is the one that the act of a party sought to be charged is not to be regarded as a proximate cause, unless it is in clear sequence with the result, and unless it could have been reasonably anticipated that the consequences complained of would result from the alleged wrongful act; that if the consequences were only made possible by the intervening act of a third party, which could not have reasonably been anticipated, then the sequential relation between act and results would not be regarded as so established as to come within the rule of proximate cause."

In 2 Sutherland on Damages, # 42, p. 159, it is said:

"If there intervenes between the defendant's act or omission a willful, malicious, and criminal act committed by a third person, which act defendant had no reason to apprehend, the connection between the original wrong and the result is broken."

The plaintiffs in effect contend that defendants are chargeable with negligence because of failure to detect Moore's wrong-doing,

wholly overlooking the fact that, although they were closely affiliated with Moore, who was constantly under their supervision, they were negligent in failing properly to supervise his acts, or to learn the true condition of their own business and to detect his wrong-doing. We have reached the conclusion that the judgment is right and should be affirmed.

Judgment and order affirmed, without costs to either party as against the other. Order filed.

MERRELL and FINCH, JJ., concur.

CLARKE, P. J. (dissenting).³ I dissent from the affirmance of so much of the judgment as sets aside the verdict of the jury assessing the damages at \$1,177,805.26. The contract of audit was not one merely to discover if inadvertent clerical errors had been made in the bookkeeping, but was one of protection of the plaintiffs' firm from their own failure to find any error in their books of account. This contract the defendants failed to perform. Admitting the neglect of the plaintiffs to discover the embezzlement and falsification of the accounts through an examination of the books on their own part, the defendants' work in pursuance of the contract, owing to the manner in which it was performed, failed to save plaintiffs from the consequences of such failure and neglect, which was the very subject of the contract.

This case was again appealed; the New York Court of Appeals affirmed without opinion the above decision, on April 6, 1926.⁴

Study the above case, and discuss the duties and liabilities which the law places on professional accountants. Do you consider the decision in this case fair? If so, why? If not, why not?⁵

³ The dissenting opinion of Presiding Justice Clarke is of particular significance to the accountant, for if this view were to be adopted by the courts, auditors would be held to be insurers of the correctness of the accounts of their clients.

⁴ 242 N. Y. 569.

⁵ In *Smith v. London Assurance Corporation* (109 App. Div. 882; 96 N. Y. S. 820) the auditor failed to verify the cash and agency accounts, and thus did not discover losses resulting from embezzlements and defalcations of a cashier. The court, in sustaining a counterclaim for damages against the auditor, quoted the following from Cooley, "The Law of Torts" (2nd ed., p. 277; 3rd ed., p. 1386):

"Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility. . . ."

See also "Legal Responsibilities of Auditors," *Harvard Business Review*, Vol. IV, No. 4 (July, 1926), pp. 500-504; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 11-14.

PROBLEM 3

RONALDSON V. MOSS & WATKINS, INC.

Practising as Certified Public Accountant without Proper Authority

Robert T. Ronaldson, a certified public accountant of Texas, performed an audit for Moss & Watkins, Inc., a Louisiana corporation, dealers for Dodge Bros. motor cars. Although the employment was covered by a contract, the client declined to pay the amount claimed to be due, and the auditor sued for the payment of professional fees earned. The statutes of the State of Louisiana make it unlawful for the holder of a C. P. A. certificate from another state to use the abbreviation "C. P. A., with or without any qualifying words or letters," or to practise as a certified public accountant in Louisiana without first having his certificate registered.¹ The work was done in Louisiana, and the reports submitted were signed "C. P. A." without qualification; Ronaldson had not registered his Texas certificate in Louisiana. The decision of Judge Cline is as follows:

FOURTEENTH JUDICIAL DISTRICT COURT

PARISH OF CALCASIEU—STATE OF LOUISIANA

ROBERT T. RONALDSON }
v. No. 14,557 }
MOSS & WATKINS, INC. }

The cause of action in this case is a written contract involving a claim of \$1,000, and an oral contract involving a claim of \$200, as reasonable compensation for services rendered. The plaintiff is a public accountant, certified in the State of Texas. The defendant is a Louisiana corporation, dealing in motor vehicles, manufactured by Dodge Bros. The contracts sued on relate to the employment of the plaintiff by the defendant to make audits of its books of account. Several defenses are tendered.

The first defense is based upon Act 136 of 1924, which makes it unlawful for any holder of a certificate as a public accountant from

¹ See Section 5, Act No. 136, Acts Passed by the General Assembly of the State of Louisiana at the Regular Session of 1924.

another state to use the abbreviation "C. P. A.," or to practice as a public accountant in this State, without having first had his certificate registered. A violation of the statute is declared to be a misdemeanor, punishable by fine and imprisonment.

It is admitted that Ronaldson holds a certificate in Texas, and has not registered it in Louisiana; and for the purpose of this discussion, it will be assumed that his demand in this case is based upon a practice of public accountancy in Louisiana, accompanied by the use of the abbreviation "C. P. A."

*Declares Policy of State*²

The theory of the defense is that the statute declares the public policy of the state, prohibiting the contract sued on, and that, therefore, the contract is null, void, and unenforceable.

A distinction is noticeable between contracts attempting to do with causes at all times illegal, and contracts having to do with causes ordinarily legal, but prohibited as to the capacity of certain persons to enter into them. The first class can never give rise to any legal rights of enforcement by any parties to them; but whether this rule always and invariably applies to the latter class may be questioned, and must now be determined.

Persons sui juris are frequently prohibited from contracting to do certain things. Practice as a physician or as a lawyer is universally prohibited except by those deemed qualified, and so certified by public authorities. In these professions the formal license issued by the State follows as a result of the qualifications of the licensee, and not primarily in consideration of the payment of the license fee. In some other callings, the license is merely a receipt for the payment of an occupation tax. This is true as to merchants, and it has been held to be essentially true in the case of brokers. The present law regulating real estate brokerage, Act 236 of 1920, however, supersedes these decisions. It not only prohibits the practice without a license, but specifically prohibits the collection of brokerage fees by those who have not complied with the act.

When Revenue Is Sole Object

When the license is a mere proof of payment of the license tax, and when recovery for such services is not prohibited in terms by statute unless the tax has been paid, the contract for services does not appear to be affected by nullity. The rigid rule that acts against public policy are null and void does not apply, for the license is not

² These subheadings did not appear in the decision, but are inserted for purposes of clarification; credit for them belongs to *The American Accountant*.

required in order to prevent the act by unauthorized persons, but only for the purpose of revenue.

It is required in this case to determine whether the Legislative enactment, making the practice of public accountancy unlawful in the absence of a certificate duly issued, strikes with nullity a contract of employment of an accountant not certified.

A competent public accountant must doubtless possess certain natural qualifications, improved by education and experience. It is clear that an incompetent accountant might injure the public seriously by malpractice. In *State v. DeVerges*, 153 La. 349, which appears to be the only Louisiana case on the subject, it is said that accountancy did not affect the morals, health, or safety of the public, however incompetent the person practising the profession might be. But the later policy declared by the Legislature, in its Act of 1924, is controlling, and can be deduced only from the act itself. The act creates a board to be appointed by the Governor. Applicants for certificates shall submit to a written examination by the board on "Theory of Accounts," or other subjects named, and on such additional subjects deemed necessary by the board. They shall prove at least a high school education, and good moral character. The board may then issue a certificate, which may be revoked, after hearing for "unprofessional" conduct. The certified accountant is prohibited from disclosing any information gained in his employment.

It is seen that the public policy of the state as set out in the Legislature, considers public accountancy as a highly skilled profession, and the regulation of its practice to be essential to the well-being of the public. The moderate fee to be paid for the certificate cannot be considered the moving cause of the enactment; it is merely incidental to the regulation deemed important in the public interest, and at most, designed to relieve the state itself of some of the cost of such regulations. The present case cannot, therefore, be compared with the several cases cited, in which licenses for brokerage were involved. On the contrary, it must be held that the public policy of the State places accountancy in the class of learned professions, and for the public protection, prohibits its practice under penalties, by those not duly qualified under the Legislative Act. It declares such unauthorized practice of the profession to constitute a misdemeanor, punishable like other violations of penal statutes, by fine and imprisonment.

Our Civil Code, Art. 1892 to 1900, refers to the object, and the cause or consideration of contracts, and declares contracts void which have an object contrary to morals or forbidden by law, or a cause

which is false or unlawful. The cause is said to be unlawful when it is forbidden by law, or is contrary to moral conduct or public order. The objects, cause and consideration of the contract in this case were the auditing of the books of account, and the receipt of money compensation therefor. Ordinarily these are lawful and commendable objects, causes and considerations. But the consideration received for services which are forbidden by a penal statute from rendering, apparently becomes an unlawful consideration, and contrary to public order, as the services themselves are an unlawful consideration for the money received.

When Claim Is Founded on Law Violation

The legal principle involved, however, does not depend upon the construction of the Codal articles. It is a principle fundamental in jurisprudence, to be extracted from all cases, "that the law will not lend its support to a claim founded upon its violation"—*Holman v. Johnson*, 1 Cowp. 343. And this must necessarily be true, whether the violation consists in doing something which is in itself prohibited generally, or whether it consists in the doing of something by a person forbidden to do what others are authorized by law to do.

In the Berghaus case, 13 La. A 210, a property owner contracted to pay a public fire fighting company for extinguishing a cotton fire. The contract was held void because, the duty of the company being to the public generally, its members were without right to contract for and receive compensation from private persons. The contract being one reprobated by public policy, and illegal, to enforce it would be to undo what the courts were created to do.

"When the law making power speaks upon a particular subject, public policy in such a case is what the statute enacts. If the law prohibited any contract . . . a contract . . . made in violation of such a law is void." *U. S. v. Freight Assn.*, 41 L. Ed. 1007.

"There can be no civil right where there can be no legal remedy, and there can be no legal remedy for that which is in itself illegal." *Ban v. Owens*, 7 L. Ed. 512.

Lord Holt is quoted in 13 C. J. 433 as saying, in an old case, that every contract made unlawful by statute is void, without express mention made thereof by the statute, because a penalty implies prohibition. The same work, Vol. 13, p. 423, declares:

"Where a license or certificate is required by statute as a requisite for one practising a particular profession, an agreement of a professional character without such license or certificate is ordinarily held illegal and void. This is true, for example, of an agreement made by

an unlicensed or uncertified physician, an attorney at law, a conveyancer, an engineer, or a school teacher. The authorities are in accord on this point, where the license is required for public protection and to prevent improper persons from acting in a particular capacity and not for revenue purposes only."

On page 424 of the same volume it is said that if an agreement binds the parties to do, or if the consideration is to do something opposed to the public policy of the state, it is illegal and absolutely void, however solemnly made.

In the early Louisiana case of *Davis v. Holbrook*, 1 A. 176, it is said: "A party will not be heard who asks the court to relieve him from consequences of having violated the law." If Ronaldson practised public accountancy in Louisiana, using the abbreviation "C. P. A.," without having registered his Texas certificate, he violated the law which declares such practice unlawful. All of the authorities say that the law will not compensate him for violating the law.

That he did practise in Louisiana without complying with our law is beyond debate. The "auditing" was done here, even assuming that the reports were written in Texas; and his reports of a Louisiana business, delivered to a Louisiana corporation for use with its home banks, signed "C. P. A." without qualification, constitutes the conducting of a Louisiana practice. He presents his suit as a Certified Public Accountant. The contract upon which he declares is a Louisiana contract. One isolated act would not constitute practice; but a continuous employment for one or more clients is habitual, and becomes "practice."

It may be said that the rigid terms of the statute were not intended to apply to qualified public accountants of other states who pursue their calling in Louisiana. The terms of the statute itself are to the contrary. Such an accountant, at the discretion of the board, may have his certificate registered without the usual examination, provided his home state grants the same privilege to Louisiana accountants; but this is a discretionary grant. Certainly the board would inquire as to good character, and presumably as to education and experience before granting the registration. Practice without such precautions is the exact thing from which our lawmakers sought to protect the public.

The contract of employment sued on having been found to be unlawful, under a statute declaring the public policy of the state, it is wholly unimportant to the law, in a suit to enforce the contract, whether it was entered into and carried out in good faith or bad

faith, or whether either party has been injured or benefited thereby. In any event compliance with the contract can never form the basis of recovery at law. However harsh this doctrine may appear, it is the duty of the courts to take the law as the lawmaker hands it down, and so enforce it according to the declared public policy of the state. We must obey this duty in the present case.

Counterclaims Not Allowed

The defendant reconvenes for recovery of money paid for audits which it declares to have been worthless, and for damages for injury alleged to have resulted from incorrect audits and reports. Both demands will be rejected. Without going into the evidence in any detail, it suffices to say that culpable malpractice by the plaintiff is not established. As to the demand for damages, there is no evidence of their infliction to any measurable extent.

It is therefore ordered, adjudged and decreed that the demands of the plaintiff and of the defendant be rejected at the cost of the plaintiff.

Thus done, read and signed in open court, at Lake Charles, Louisiana, this 6th day of August, 1928.

(Signed) JERRY CLINE
District Judge

Study the above case, giving special attention to the court's statement of the relation of the public accountant to business and to the public welfare generally.

PROBLEM 4

AMERICAN INSTITUTE OF ACCOUNTANTS

Rules of Professional Conduct

The rules of professional conduct for those engaged in the public practice of accounting, as prepared by the American Institute of Accountants committee on professional ethics, and as approved by the Council of the Institute on September 19, 1927, are as follows:¹

¹ These rules of professional conduct have been in existence for a number of years; various slight changes have been made in them from year to year, but the essential principles have remained the same. The only change made during the year from September 20, 1926, to September 19, 1927, was the elimination of the words "or otherwise" following the phrase "to be published in the public prints" appearing in the first sentence of paragraph (11).

(1) A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates), provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, all the individual members of which are not members of the Institute (or in part members and in part associates), or an individual practising under a style denoting a partnership when in fact there be no partner or partners or a corporation or an individual or individuals practising under a style denoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."²

(2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospec-

² Other accounting societies have promulgated somewhat similar rules, one of the most recent of these codes of ethics being that adopted by the Pennsylvania Institute of Certified Public Accountants at its annual meeting, June 20, 1928. This code, which had previously been reviewed by the council and by the Philadelphia and Pittsburgh chapters, was ratified after minor changes; these rules of professional conduct are as follows:

"Preamble. Members shall at all times uphold the honor and maintain the dignity of the profession.

"1. A member may describe himself as 'Member of the Pennsylvania Institute of Certified Public Accountants.' A partnership, all of whose members are members of the Institute, may describe itself as 'Members of the Pennsylvania Institute of Certified Public Accountants.'

"2. A member shall conform to the laws of the state in which he may be engaged in practice regularly or temporarily in respect to the use of the designation 'certified public accountant' or other descriptive term.

"3. A member shall not allow any person to represent him in practice who is not in partnership with him or a member of his staff, or who is not a regularly practising public accountant in good standing.

"4. No member shall approve, sign or certify accounts, statements or other forms of accountancy work which have not been verified under the supervision of himself, or a person representing him in conformity with rule 3 of these canons. No member shall prepare or certify any statement which contains an essential misstatement of fact or which conceals such a fact as would amount to an essential misstatement or would result in a failure to put interested parties on notice in respect to a material fact not specifically shown on such statement.

"5. No member shall engage in any other occupation or business conjointly with his professional practice as a certified public accountant, which is not compatible or consistent therewith.

"6. A member shall hold inviolate, as confidential, all information obtained from a client or from his records, except as permission to disclose information is obtained from the client, or as disclosure may be required by law.

"7. A member shall not represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts as to the engagement.

"8. No member shall undertake to render professional services on such terms or under such circumstances as would tend to impair the standing of the certified public accountant in the eyes of the business public.

"9. No member shall allow or pay, directly or indirectly, to the laity, any commission, brokerage or other participation in, the fees, proceeds or profits of his professional work; neither shall he accept or receive, directly or indirectly from the laity, any commission, brokerage or other participation for professional or commercial business turned over to others as an incident to his services to clients, except with the consent of and for the benefit of the client.

"10. A member shall not knowingly solicit the clients of another member by personal appeal or by letter or in any other way, or encroach upon another's professional practice. This rule shall not be construed to deny the right to render service to any person, firm or corporation specifically requesting it.

"11. A member shall not offer employment directly or indirectly, to the employees of another certified public accountant without first informing the said accountant of his intent.

tive investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation of proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable.

(3) No member or associate shall allow any person to practise in his name as a public accountant who is not a member or an associate of the Institute or in partnership with him or in his employ on a salary.

(4) No member or associate shall directly or indirectly allow or agree to allow a commission, brokerage or other participation by the laity in the fees or profits of his professional work; nor shall he accept directly or indirectly from the laity any commission, brokerage or other participation for professional commercial business turned over to others as an incident of his services to clients.

(5) No member or associate shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the executive committee or of the council is incompatible or inconsistent therewith.

(6) No member or associate shall certify to any accounts, exhibits, statements, schedules or other forms of accountancy work which have not been verified entirely under the supervision of himself, a member of his firm, one of his staff, a member or an associate of this Institute or a member of a similar association of good standing in a foreign country which has been approved by the council.

(7) No member or associate shall take part in any effort to secure the enactment or amendment of any state or federal law or of any regulation of any governmental or civic body, affecting the practice of the profession, without giving immediate notice thereof to the secretary of the Institute, who in turn shall at once advise the executive committee or the council.

(8) No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.

This rule shall not be construed to prohibit negotiations with anyone, who, of his own initiative, shall apply to a member for employment.

"12. No member shall advertise in a manner detrimental to the dignity of the profession.

"13. Any member taking part in efforts to secure the enactment or amendment of legislation affecting the practice of the profession shall give immediate notice thereof to the secretary of the institute, who in turn will advise the council.

"14. Any member violating any of the above canons or being guilty of any act or omission discreditable to a certified public accountant shall become liable to discipline under the provisions of article XI, section 1, of the by-laws."

(9) No member or associate shall directly or indirectly offer employment to an employee of a fellow member or associate without first informing said fellow member or associate of his intent. This rule shall not be construed so as to inhibit negotiations with any one who of his own initiative or in response to public advertisement shall apply to a member or associate for employment.

(10) No member or associate shall render or offer to render professional service, the fee for which shall be contingent upon his findings and the results thereof.³

(11) No member or associate of the Institute shall advertise his or her professional attainments or service through the mails, in the public prints, by circular letters or by any other written word except that a member or an associate may cause to be published in the public prints what is technically known as a card. A card is hereby defined as an advertisement of the name, title (member of American Institute of Accountants, C. P. A., or other professional affiliation or designation), class of service and address of the advertiser, without any further qualifying words or letters, or in the case of announcement of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories and similar publications cards shall not exceed one quarter page in size.⁴ This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among a member's own cli-

³ With reference to contingent fees, a rather significant resolution was adopted on May 19, 1921, by the Louisiana State Board of Accountants, viz.: "That the Louisiana State Board hereby notifies all holders of certificates issued under the authority of the state of Louisiana that from and after this date it will be considered as unprofessional conduct for any certified public accountant to accept employment on the basis of a contingent fee for services rendered a client. Any violation will subject such parties to trial by this board for a violation of section 7, of act 125 of 1908." The resolution is signed by Charles E. Wermuth, Elkin Moses and Guy V. W. Lyman, members of the state board of accountants.

⁴ At the quarterly meeting of the District of Columbia Institute of Certified Public Accountants held December 19, 1928, this resolution was adopted:

"Whereas it is the consensus of opinion of the individual members of the District of Columbia Institute of Certified Public Accountants that the money now expended in display or professional card advertising in the directories is, at least in spirit, violative of professional ethics, and

"Whereas the members of the Institute recognize that certain educational measures could be used to the benefit of the certified public accountant and his client; therefore be it

"RESOLVED that the District of Columbia Institute favors and urges the individual members of the Institute to discontinue individual display or professional card advertising in the directories; and further

"RESOLVED that the District of Columbia Institute recommends the use of space in the classified section of the telephone directory for group advertising of an educational nature; and be it further

"RESOLVED that it is the consensus of opinion and the recommendation of the Institute that the Educational Advertising Campaign Committee be requested to give its consideration to the immediate development of a plan for the educational advertising so that if possible the plan can be approved at a special meeting of the Institute early in January, if that is thought necessary, and the advertising actually be gotten under way not later than January 10."

ents or personal associates or the properly restricted circulation of firm bulletins containing staff personnel and professional information.⁵

Study the above rules of professional conduct, and discuss their importance in relation to a profession of accountancy.⁶

PROBLEM 5

SACRAMENTO WOOLEN MILLS

Change in Audit Date to Give Better Financial Standing

The Sacramento Woolen Mills of Lowell, Mass., had for years closed its fiscal period as of April 30. Each year its accounts had been audited by a prominent firm of certified public accountants in Boston. In accordance with established custom it instructed the firm of accountants to audit its accounts for the fiscal year ended April 30, 1925.

During the course of the verification the auditors found that during March, 1925, the company had entered into a purchase contract to buy 1,000,000 pounds of unwashed Ohio Fine Delaine wool at a price of 63½ cents per pound.¹ At April 30, none of

¹ Wool prices (1927 *Annual Statistical Bulletin*, January 20, 1927, p. 881), Ohio Fine Delaine—Unwashed, Average of prices at Boston:

January, 1925	70.38 cents
February	68.63
March	63.50
April	54.70
May	49.00

⁵ An addition to the rules of professional conduct of the American Institute of Accounts was proposed at the meeting of council on April 8, 1929. The council approved the proposed rule by mail ballot and the president of the Institute declared the rule effective May 16, 1929. The text of the rule, which will be No. 12, is as follows:

"No member or associate of the Institute shall be an officer, a director, stockholder, representative, an agent, a teacher or lecturer, nor participate in any other way in the activities or profits of any university, college or school which conducts its operations, solicits prospective students or advertises its courses by methods which in the opinion of the committee on professional ethics are discreditable to the profession."

⁶ See, in addition, Montgomery, *Auditing, Theory and Practice*, 4th rev. ed., p. 52; Forbes, "Some Phases of Professional Ethics," *Journal of Accountancy*, Vol. XX (October, 1915), pp. 271-275; Joplin, "Ethics of Accountancy," *Journal of Accountancy*, Vol. XVII (March, 1914), pp. 187-196; Sterrett, "Professional Ethics," *Journal of Accountancy*, Vol. IV (October, 1907), pp. 407-431; French, "Professional Ethics," *Journal of Accountancy*, Vol. XXXVI (August, 1923), pp. 81-96; Reckitt, "Professional Ethics," *Journal of Accountancy*, Vol. XLII (August, 1926), pp. 88-96.

this wool had actually been delivered so that the entire commitment on the part of the company was unmet; however, the price of wool had dropped to approximately 54 cents per pound. The auditors deemed it necessary, therefore, to take up in the accounts or to refer by footnote on the balance sheet to the contingent liability which existed. This amounted to approximately \$95,000 as of April 30; by the end of May, at which time the audit was practically completed, the price of wool had dropped still further to approximately 49 cents per pound.

The officials of the Sacramento Woolen Mills objected to any reference being made in the published accounts to the drop in prices which had occurred since entering into this purchase contract. They accordingly proposed to the auditor that for 1925 the date of the balance sheet be changed and instead of the published accounts being prepared as of April 30 they be prepared as of March 31. At March 31 there would be no contingent liability resulting from the drop in prices of wool contracted for; furthermore, in certain other respects the balance sheet of the company would appear more favorable if prepared as of March 31 than if prepared as of April 30.

Should the auditor certify the accounts without qualification as of March 31?

PROBLEM 6

IPSWICH MILLS V. WILLIAM DILLON AND ANOTHER

Ownership of Auditor's Working Papers

Ipswich Mills, a corporation located in the Commonwealth of Massachusetts, employed William Dillon, Certified Public Accountant, from 1912 or 1913 to make an annual audit of its accounts, prepare tax returns, and perform various bookkeeping services for the company. In 1921 Mr. Dillon took his son into partnership with him, the firm being known as William Dillon & Son; the above employment continued until December, 1925. About that time the client demanded that the auditors surrender

to it "all papers in your possession belonging to Ipswich Mills." No papers were delivered, and a bill in equity was filed in the Massachusetts Superior Court on February 25, 1926, to compel the accountants to deliver to the company all work sheets, letters, and other papers connected with the case.¹

The Massachusetts Superior Court entered a decree which was so unsatisfactory to the accountants and to counsel that an appeal was made to the Supreme Judicial Court of Massachusetts.² Even the trial judge in the lower Superior Court stated, after writing his decision, that the case should be appealed, because he had no precedent to guide him.

The decree entered by the lower court was to the effect that the working papers of the accountant in his ordinary work as a public accountant belonged to the client, but that the accountant could make copies of the papers, or if delivered to the client without making copies, the defendant accountant must be given a bond for their preservation and production at any time required in the future. The lower court also held that the work sheets of the accountant prepared in a tax case under a power of attorney were different from the other working papers prepared in the ordinary work of a public accountant, and that the client and the accountant had joint ownership therein because the accountant was engaged by the client as an attorney in fact. Even in this situation, however, the lower court held that the work sheets were to be delivered to the client under the bond provision outlined above. The result of this decision would be to deprive an auditor of the possession of all his working papers.

The decision of the Supreme Judicial Court of Massachusetts is given in full herewith: ³

¹ No previous decisions on this point had been made by any court in the United States, and, so far as could be learned by able counsel, by any court in England. The Massachusetts ruling, therefore, sets a precedent, one of great value and importance to public practitioners of accountancy. However, as early as 1923, the author made the statement, based upon the opinion of some of the most eminent counsel in New York, that "the working papers or records are the sole property of the auditor and should remain in his possession." See Jackson, *Audit Working Papers*, p. 5.

² Recognizing the importance of the point at issue, the American Institute of Accountants, through its counsel, joined with the counsel of the defendant accountant in defending the case. It should be noted that practically all the points made by the lower court are reversed in the decision of the higher court; the higher court even found, among other things, that the accountant is an independent contractor engaged in his own occupation, and is not an agent or servant of the client.

³ 260 Mass. 453.

IPSWICH MILLS V. WILLIAM DILLON AND ANOTHER

Suffolk. Argued March 8, 1927.

Opinion filed July 5, 1927.

Present: Rugg, C. J., Braley, Pierce, Carroll and Wait, JJ.

Accountant, Ownership of letters, work sheets, and memoranda.

Agency, Independent contractor.

Reservation and report by Weed, J., of a suit in equity heard by him in the Superior Court.

Carroll, J. The question involved in this suit in equity is the ownership of certain papers. The plaintiff is a manufacturer of hosiery. The defendants are accountants, father and son, who have been partners since January 1, 1921. In 1912 or 1913 the father, and later the firm, were employed by the plaintiff as accountants to make an annual audit, to prepare tax returns, and to perform services on matters of bookkeeping, cost accounting and statements for banks. This employment continued until December, 1925. In 1922 or 1923 the defendants were employed to conduct a Federal tax case before the bureau of internal revenue as attorneys in fact for the plaintiff. While a Federal revenue agent was making an examination of the plaintiff's returns for the years 1922, 1923, 1924, he was sent by the plaintiff to the defendants to examine certain papers in their possession relating to the plaintiff's affairs, more particularly the defendants' "work sheets" relating to the revaluation of the plant assets and to certain adjusted inventories developed in their work on the tax case. The defendants refused the revenue agent access to these papers. On January 6, 1926, the plaintiff demanded of the defendants "all papers in your possession belonging to Ipswich Mills." No papers were delivered and this suit was instituted.

*Papers Produced at Trial*⁴

All the papers involved which were in the defendants' possession were produced by them at the trial. They were examined by the parties, grouped, initialed and impounded, awaiting the final decision of the case. Group A consisted of papers that originated in the plaintiff's office or in the office of its selling agents, or of some one associated with them, including papers relating to the 1917 Federal tax return of the plaintiff. The defendants conceded that the

⁴ These subheadings did not appear in the decision, but are inserted for clarification; credit for them should go to *The American Accountant*.

plaintiff is the owner of these papers in Group A, and entitled to possession of them. Group B included a copy of the amended Federal tax return of the plaintiff for the year 1918, and certain papers (not work sheets) relating thereto. In Group C there were copies of the plaintiff's tentative and amended tax return for 1919 with work sheets and correspondence in connection therewith. In Group D were papers and work sheets of the revaluation of the plaintiff's plant assets. The papers in Group E were the defendants' work sheets of their July, 1922, report. Group F included papers, reports, returns, copies, work sheets, data, correspondence and memoranda respecting the tax case, together with some letters originating in the plaintiff's office.

Work Sheets Defined

It was found by the trial judge that "work sheets" meant papers on which original compilations, computations and analyses are made by accountants, which later are gathered together in a summary form and the figures rendered in a schedule, exhibit, report or return upon which the accountant is working. The judge ruled that the plaintiff was the owner of the papers in groups B, C, D and E, and entitled to the immediate possession of them, the defendants being entitled to take and preserve such photostatic copies as they desired. With reference to the papers initialed F, the judge ruled that the parties were jointly interested in these particular papers, with the right in the plaintiff to take them temporarily from the defendants. An order for a decree was made. The case was then reported to this court.

Concerning the papers marked B, which consist of "copy of amended Federal tax return of the plaintiff for 1918 and certain papers (not work sheets) relating thereto," the judge found "the defendants were under employ as accountants,—auditing, checking up and verifying, and making a research for the original costs of the plaintiff's plant assets then in use and applying depreciation figures decided upon by the directors with respect to the different classes of property. It was work of a character requiring accounting skill and experience, and good judgment in reaching sound and dependable conclusions where original entries were obscure or vouchers missing. It was fully paid for by the plaintiff." We assume that the original tax return was delivered to the plaintiff and the copy of this return retained by the defendants. The defendants were not the agents or servants of the plaintiff, they were independent contractors. In the making of the documents and papers and in collecting the information

involved in them, the defendants were independent accountants engaged in their own occupation. See *Pearl v. West End Street Railway*, 176 Mass. 177, 179; *Leverone v. Arancio*, 179 Mass. 439, 443. They had the right to make and retain copies of the tax return. It might be necessary to have possession of the copies if the accuracy of their work was questioned. There was nothing in the contract of employment which required the defendants to surrender this copy and in the absence of such an agreement they could not be compelled to surrender it. The other papers relating to the Federal tax return of 1918, mentioned in Group B, we understand are office copies of letters sent by the defendants. The defendants could retain copies of these letters as well as copies of the schedules which are indicated by the evidence as being a part of the "papers . . . relating thereto." This copy of the return and the papers relating thereto may have contained information of importance to the plaintiff. The right of the plaintiff to restrain its publication is not before us. Even if it be assumed that the defendants could be enjoined from the publication of the contents of these papers, the title to them was in the defendants.

Ruling as to Letters

Group C consisted of (1) carbon copies of letters from the defendants to the plaintiff; (2) original letters from the plaintiff to the defendants; (3) original letters to the defendants from the plaintiff's attorneys; and (4) carbon copies of letters from the defendants to the collector of internal revenue.

The carbon copies of the defendants' letters to the plaintiff were the property of the defendants. The plaintiff did not own these copies and was not entitled to their possession. The contract of employment did not require the defendants to furnish these copies to the plaintiff.

The original letters from the plaintiff to the defendants belonged to the defendants. They were the recipients, and therefore owned them. It was decided in *Baker v. Libbie*, 210 Mass. 599, 606, after an exhaustive review of the authorities, that as a general rule the publication of letters may be restrained by the author, but in the absence of some special arrangement the recipient of the letter is the owner. "The author parts with the physical and material elements which are conveyed by and in the envelope. These are given to the receiver. The paper upon which the letter is written belongs to the receiver. *Oliver v. Oliver*, 11 C. B. (N. S.) 139. *Grigsby v. Breckinridge*, 2 Bush, 480, 486. *Pope v. Curl*, 2 Ark. 341. *Werckmeister*

v. American Lithographic Co., 142 Fed. Rep. 827, 830. A duty of preservation would impose an unreasonable burden in most instances. It is obvious that no such obligations rest upon the receiver, and he may destroy or keep at pleasure." The same principle is applicable to the letters sent from the plaintiff's attorneys to the defendants. As the defendants were the receivers of these letters, they were the property of the defendants.

Tax Letters Owned by Defendants

The carbon copies of the defendants' letters to the collector of internal revenue did not belong to the plaintiff. Whatever right it may have to examine these copies, or take copies of them, which point we are not called upon to decide, the defendants' copies did not belong to the plaintiff; they were owned by the defendants. The fact that the copies of these letters concern the plaintiff is not a sufficient reason for depriving the defendants of their property. In writing the letters the defendants were not the plaintiff's servants. In Group C there are copies of Federal tax returns. These, as we understand from the record, were the defendants' office copies. The record shows that copies of all returns and schedules prepared by the defendants for the plaintiff were sent to the plaintiff. Even if the plaintiff has a right to require further copies, a question not involved in this suit, it has no right to demand of the defendants the surrender of these office copies. They were the property of the defendants.

Rulings as to Work Sheets

The work sheets, as defined by the trial judge, were the defendants' property. They were made by them while engaged in their own business. The paper on which the computations were made belonged to them. They were not employed to make these sheets. The sheets were merely the means by which the work for which the defendants were employed might be accomplished. The title to the work sheets remained in the defendants after the computations were made. In the absence of an agreement that these sheets were to belong to the plaintiff, or were to be held for it, they were owned by the defendants. It may be that these papers contained information confidential in its nature and of importance to the plaintiff; but the defendants did not receive this information as the plaintiff's servants. It has been held that plans prepared by an architect employed for that purpose belong to the one for whom they are made. *Walsh v.*

St. Louis Exposition & Music Hall Association, 101 Mo. 534, 535. *Gibbon v. Pease*, (1905) 1 K. B. 810. See *Kutts v. Pelby*, 20 Pick. 65, 66. But it has never been decided so far as we know that the preliminary plans and sketches of an architect belong to the person by whom the architect is employed, see in this connection *Rutan v. Coolidge*, 241 Mass. 584; nor has it been held so far as we are aware that the preliminary sketches and drawings of an artist employed to paint a portrait belong to the sitter; or that memoranda made by a physician of his examination of a patient, or the notes and records of a lawyer, his preliminary drafts of legal documents or his minutes of testimony, belong respectively to the patient or client. See *Anonymous Case*, 31 Maine 590; *In re Wheatcroft* 6 Ch. D. 97. As to property rights in a negative where a photograph is taken for pay in the usual course, see *Boucas v. Cooke*, (1903) 2 K. B. 227, 238; *Pollard v. Photographic Co.*, 40 Ch. D. 345. The interest of the plaintiff in the information collected and copied by the defendants and the confidential nature of this information do not give title to the plaintiff of the defendants' working papers. They were made by the defendants solely for their own assistance in preparing the tax returns.

Same Ruling on Tax Papers

With reference to Group F, the letters addressed to the defendants, copies of letters written by the defendants, copies of returns furnished to the plaintiff, and work sheets relating to the tax case, are the sole property of the defendants, and this is true of the papers and reports collected by the defendants in the preparation of the tax case. The plaintiff is not jointly interested with the defendants in these documents. We do not understand that any of these reports, papers and returns were property of the plaintiff which had been placed in the defendants' custody by the plaintiff or merely delivered to the defendants. If there are any papers belonging to the plaintiff which were lent to the defendants, the plaintiff is entitled to them, but as we construe the record, the papers referred to in Group F were gathered and collected by the defendants in the course of their business, and were not papers of the plaintiff placed by it in the defendants' possession.

No Right Given to Client

On the record of the evidence disclosed in this case, the defendants were under no legal obligation to surrender their working sheets or other papers to the plaintiff. The testimony of Leonard and Dillon does not prove that the defendants gave the plaintiff any right

or title in them. It is apparent that at one time papers in the possession of the defendants, including their working papers, were turned over to the plaintiff for which receipts were given by the plaintiff to the defendants. These papers were again returned to the defendants. The plaintiff contends that by this transaction the plaintiff's rights of property and possession of all these papers were settled. Dillon testified that these papers were merely lent to the plaintiff. An investigation of the letters and receipts, and an examination of the record, do not satisfy us that the defendants in placing these documents in the possession of the plaintiff intended to part with their title and property in them.

It follows that the papers in Group A belong to the plaintiff. The other papers and documents belong to the defendants. A decree is to be entered for the plaintiff, directing that the plaintiff is the owner and entitled to immediate possession of the documents described in Group A.⁵

Ordered accordingly.

R. G. Dodge, and J. H. Covington of the District of Columbia, for the defendants.

John S. Stone, for the plaintiff.

S. Gordon of the District of Columbia, by leave of the Court, filed a brief as *amicus curiae*.

Be prepared to discuss the various points brought out in the above case.

⁵ It should be noted that on March 26, 1928, the Governor of Virginia signed a new bill "to amend and re-enact Sections 566, 567, 568, 569, 570, 571, and 572 of the Code of Virginia, relating to the State Board of Accountancy, and to add a new section relating thereto, designated as Section 572-a." It is the first paragraph of this new section which is of particular interest; it reads as follows:

"Section 572-a. All statements, records, schedules and memoranda made by a certified public accountant or a public accountant, or by an employee or employees of a certified public accountant, or public accountant, incident to or in the course of professional service to clients by such certified public accountant, or public accountant, except reports submitted by a certified public accountant, or public accountant, to a client shall be and remain the property of such certified public accountant, or public accountant, in the absence of a written agreement between the certified public accountant, or public accountant, and the client, to the contrary."

On June 1, 1927, or nearly ten months earlier, an act containing almost the identical words given in the Virginia statute was approved by the Governor of Florida; see Florida General Laws, 1927, Chapter 12290, p. 1224. It is not improbable that many of the States will enact similar sections as the statutes regulating public accountancy are changed or re-enacted from time to time.

PROBLEM 7

SAMUEL CRANE & BROS., INC.

Protection of Auditor's Working Papers

Samuel Crane & Bros., Inc., operate a chain of theatre ticket agencies, with headquarters in New York City. Accounts with theatres are reconciled and settled monthly, though occasionally settlements are for a longer period. Each branch office of the company makes its own settlements with theatres; a daily report is then sent by each branch to the head office in New York City.

At the Washington, D. C., office of the company the cashier and his assistant, both of whom were young men nineteen years of age, and friends since childhood, were not only in charge of the cash, but also kept all of the books. Both young men were from highly respected and well-known families.

In February, 1926, one of the Washington creditors of the company presented to the New York office a statement of account covering the past five months and amounting to \$1,567.48; this amount the creditor claimed was unpaid. The manager of the Washington office was called on the telephone, and asked concerning the matter; after looking up the account, he reported that it had been paid. The creditor was told that the matter would be looked into at once, and a report made to him.

The company then employed you, a public accountant located at 120 Broadway, New York, to proceed to Washington, investigate the situation with reference to this creditor, and make your report directly to the home office in New York. You went to Washington on March 13, and immediately began your examination of the accounts. A few days later you received a letter from New York from the treasurer of the company informing you that another creditor had made a complaint similar to that made by the first party; in this letter you were instructed, because of the suspicions aroused, to make a complete detailed audit. This you proceeded to do.

By March 20 you had found a number of discrepancies which you were unable to understand; you questioned the cashier and

his assistant regarding them, but got no satisfactory explanation. That evening, as usual, you carefully placed all of your papers in your brief case, locked the case, and placed it in the company's safe.

When you came to work on the morning of March 21 you found the office in great confusion. During the night the safe had been opened; \$3,300 in cash, a large number of pages from the books, and your brief case containing all of your working papers were missing. The cashier likewise had disappeared. A careful search was made, but no trace of them was found.

What would you do?

Part II—The Audit: Preliminary Considerations

PROBLEM 8

NEW YORK SHADE CLOTH COMPANY Inquiry Regarding Cost of Annual Audit

The New York Shade Cloth Company, Buffalo, New York, manufactured cloth for window shades and sold it to jobbers throughout the eastern section of the United States. The company was incorporated in 1910 under the laws of the state of New York. The stock of the corporation was very closely held, more than 90% of the total amount outstanding being held by the officers of the company, or by the members of their families. The officers were as follows:

President	H. W. Hickman
Vice-President	J. L. Hausermann
Secretary-Treasurer	T. B. Olliphant

The company's fiscal year coincided with the calendar year; for the year 1928 the sales amounted to approximately \$540,000. The company's accounts had never been audited, but early in 1929 the officials of the company decided that it would be desirable to have an independent examination made of the books and accounts for the fiscal year ending December 31, 1928; accordingly, Mr. Hausermann and Mr. Olliphant were authorized and instructed to make arrangements for such an audit.

On the morning of February 27, Mr. Olliphant telephoned Messrs. Burrows, Kilroe & Co., Certified Public Accountants, Buffalo, that his company was considering an audit of its accounts for the year 1928, and that he would be glad to have a representative of their firm call and discuss the matter. Accordingly, Mr. Burrows called at the company's office at eleven

o'clock that morning, and discussed with Messrs. Hausermann and Olliphant the nature and scope of the work that might be done; Mr. Burrows explained briefly what was meant by a balance sheet audit and by a detailed audit, and estimated how long it would take for each.¹ After some discussion it was agreed that the most satisfactory thing would be a balance sheet audit as at December 31, 1928, including a review of the profit and loss accounts for the year then ended; it was also decided that a detailed check should be made of two months' transactions chosen at random by the auditor.

From the discussion it appeared that the accounts of the company were well kept, but that no cost system interlocking with the general accounts was maintained. The company's terms of sale were 2% discount for payment on or before the 10th of the month following the date of sale, net sixty days. The balance sheet as at December 31, 1928, per the company's books, may be summarized as follows:

CURRENT ASSETS:

Cash	\$ 8,519.80	
Accounts and Notes Receivable	69,525.29	
Marketable Securities	62,700.00	
Inventories	<u>112,391.46</u>	\$253,136.55

FIXED ASSETS:

Real Estate	\$ 27,817.92	
Buildings, less Reserve for Depreciation	85,007.82	
Machinery and Equipment, less Reserve for Depreciation	<u>34,840.76</u>	147,666.50

<u>DEFERRED CHARGES</u>		14,971.56
		<u>\$415,774.61</u>

CURRENT LIABILITIES:

Accounts Payable	\$ 53,142.53	
Notes Payable	<u>25,000.00</u>	\$ 78,142.53

NET WORTH:

Capital Stock	\$250,000.00	
Surplus	<u>87,632.08</u>	337,632.08
		<u>\$415,774.61</u>

The cost of the audit was next discussed. Mr. Burrows stated that his firm's fees were based upon the following per diem rates:

¹ See Jackson, *Audit Working Papers*, pp. 7-9; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 60-63, 78-82; Bell, *Auditing*, pp. 6-10; Kohler and Pettingill, *Principles of Auditing*, pp. 15-22.

Senior accountant	\$30.00
Junior accountant	20.00
Principal, in so far as his time was needed for supervision and for review of the accounts	50.00

and that, on this basis, the first year's examination would probably cost between \$800 and \$1,000. Mr. Burrows further stated that certain additional work was required in the case of a first audit, such as the verification and analysis of the capital assets, the analysis of the surplus and capital stock accounts, and the verification of the inventory at the beginning as well as the close of the period under review; all of this would result in the fee being somewhat larger for the first audit than for subsequent ones. With reference to the capital assets, it was stated by the company officials that no appraisal had ever been made, and that the assets were valued at cost.

Upon his return to his office, Mr. Burrows dictated a memorandum embodying the materials given above; this memorandum would then be available, in case the audit was actually undertaken, for the senior assigned to be in charge of the work.² Mr. Burrows then wrote the following letter to Mr. Olliphant with reference to the audit of the New York Shade Cloth Company:

Marine Trust Building,
Buffalo, New York,
February 27, 1929.

Mr. T. B. Olliphant,
New York Shade Cloth Company,
Buffalo, New York.

Dear Sir:

In confirmation of our conference of today, relative to the audit of the books and accounts of your company for the year 1928, we shall be pleased to perform a balance sheet audit as at December 31, 1928, including a review of the profit and loss accounts for the year then ended, and in addition will make a detailed check of two months' transactions as determined by conference with you. Upon the completion of the audit we shall prepare and submit a detailed report on your accounts; it is our understanding that you do not desire us to prepare your Federal income tax return.

² For detailed instructions with regard to beginning the work of an audit see Jackson, *Audit Working Papers*, pp. 9-16; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 40-56; Bell, *Auditing*, pp. 26-35; Kohler and Pettingill, *Principles of Auditing*, pp. 26-38.

We shall undertake the audit on the basis of the following per diem rates:³

Senior accountant	\$30.00
Junior accountant	20.00
Principal	50.00

On this basis we estimate the probable cost of the audit for the current year at between \$800 and \$1,000; as stated to you this morning, the fee for subsequent audits will probably not be so large, inasmuch as certain additional work is necessary in the case of the first audit.

Upon receipt of definite instructions from you, we shall proceed with the work of the examination.

Yours very truly,

(Signed) BURROWS, KILROE & Co.

Certified Public Accountants

Discuss briefly the above situation; in what other ways might Mr. Burrows properly have approached the New York Shade Cloth Company with reference to the audit of its accounts? Give reasons for your answers.

PROBLEM 9

MESSRS. SCROOGE & MARLOWE

Memorandum of Instructions Received

On November 15, 1928, a telephone request was received by Messrs. Scrooge & Marlowe, Certified Public Accountants,

³It is important that the basis of compensation should be arranged beforehand, even though, in case litigation is necessary, the auditor might obtain witnesses who would testify that the work measures up to the usual standard of professional work, and the court would grant him the usual professional fee. The rules of law applicable to fixing compensation for expert or professional services, as set forth in *Corpus Juris* (6 C. J. 750-2 and notes), are as follows:

"The circumstances to be considered in determining the compensation to be recovered are the amount and character of the services rendered; the labor, time and trouble involved; the nature and importance of the litigation or business in which the services were rendered; the responsibility imposed; the amount of money or the value of the property affected by the controversy, or involved in the employment; the skill and experience called for in the performance of the services; the professional character and standing of the attorney; the results secured; and whether or not the fee is absolute or contingent, it being a recognized rule that an attorney may properly charge a much larger fee when it is to be contingent than when it is not. The financial ability of defendant may also be considered by the jury, not to enhance the amount above a reasonable compensation, but to determine whether or not he is able to pay a fair and just compensation for the services rendered, or as an incident in ascertaining the importance and gravity of the interests involved in the litigation. But what is a reasonable fee must in a large measure depend upon the facts of each particular case, and be determined like any other fact in issue in a judicial proceeding. While opinions are receivable and entitled to due weight, the courts are also well qualified to form an independent judgment on such questions, and it is their duty to do so."

See also "Ethical Problems in Methods of Building Practices by Young Public Accountants; with Discussion," *The Certified Public Accountant*, January, 1929, pp. 16-20, 25.

120 Broadway, New York City, to send a representative to the executive office of The Tin Products Manufacturing Company, 350 Madison Avenue, New York City, to discuss with the officials of the Company the question of an audit of its accounts. Accordingly, a representative of Messrs. Scrooge & Marlowe called upon the above company, and discussed in detail the desirability of an audit, the scope of the proposed audit, whether a certified balance sheet or a detailed report or both were desired, and the probable cost of the work to be done. Upon his return to 120 Broadway the representative prepared the customary memorandum¹ of instructions received, as follows:

New York City, November 15, 1928.

Memorandum No. 101

Office Manager and Files:

*The Tin Products Manufacturing Company,
350 Madison Avenue, New York City*

This morning we received a telephone request to send a representative to the New York executive offices of the company to discuss with the Executive Vice President and Comptroller the question of an audit of the company's accounts as at October 31, 1928, for the year ended that date.²

In accordance therewith an interview was had this afternoon with Mr. Percival Sley, Executive Vice President, and Mr. Felix Holt, Comptroller. It was stated that the company had been organized in 1913 under the laws of the State of New Jersey; the company had never had a regular audit, and so the Directors had decided to request our advice and suggestions as to the kind of audit which would be most helpful to them. Mr. Sley stated that, although the company had no borrowed money at the present time, it might be desirable to undertake some financing in the comparatively near future in view of the increasing size of the business.

The company's plant is located at Elizabeth, N. J., and its main product is tin boxes, ranging in size from those used by typewriter companies

¹ Such memoranda are prepared in a variety of forms; two variations from the above are shown as Exhibits 3 and 4, Appendix B, of Jackson's *Audit Working Papers*, and a still different form is shown in Kohler and Pettingill's *Principles of Auditing*, p. 24. See also Castenholz, *Auditing Procedure*, pp. 391-392; Bell, *Auditing*, pp. 15-20; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 40-52.

² One of the most important preparatory considerations for the auditor is to know with certainty who is the client in the case. Great inconvenience, if not actual loss, may thus be avoided; nearly every experienced accountant has known of instances in which greater understanding in the beginning would have saved unpleasantness later on. In a New York case (*Ernst et al. v. Cary Safe Company*, 113 Misc. Rep. 620; 185 N. Y. S. 168) the president of a corporation who took no active part in the management of the business, except occasionally to preside over meetings of the board of directors, was considering the purchase of the stock of his associates; he employed a firm of accountants to audit the books, to determine for him the value of the capital stock. The books of the corporation were made available to the accountants by the treasurer of the company, who specifically stated to the accountants that it must be understood that the examination was the personal affair of the president and not that of the company. The president died before the work was completed, and the accountants brought action against the company for the amount claimed to be due; the court held that the corporation was not liable. In its decision the court said in part:

for ribbons to those used by professional men and others for storing semi-valuable papers. It also maintains sales offices in New York City, Chicago, Baltimore, Dallas, and San Francisco. A recent balance sheet and income statement were produced from which the following information was noted: capital stock is \$1,500,000; accumulated earned surplus is \$300,000; the annual sales are about \$2,500,000; capital additions for the past year (the year to be audited) were \$100,000; the inventories are \$500,000, and the accounts receivable \$600,000. Investments amounted to \$350,000, which, upon inquiry, were found to consist principally of a 90% interest in the capital stock of the Tin Products Export Company, a subsidiary formed to handle the export sales. Mr. Holt stated that the accounts of this company had never been consolidated with those of the parent company; the Export Company had never made any money, and now owed the parent company some \$200,000 on current account. We pointed out that a more correct presentation of The Tin Products Manufacturing Company's financial position would be obtained by consolidating its accounts with those of the subsidiary. Mr. Sley agreed with this suggestion but Mr. Holt dissented and stated that one reason for not consolidating the accounts was that Mr. Blank, the Manager of the Export Company and who owned the remaining 10% of the capital stock, intended to take over the whole export business as soon as it was on a profitable basis. After further discussion it was decided not to consolidate the accounts of the Export Company with those of the parent company.

The scope of the proposed audit was then discussed. Mr. Sley was in favor of some sort of limited-test audit, with a brief certification so that the balance sheet could be used for credit purposes with banks. Mr. Holt thought that a detailed report would be of more value to the executives, and that we should examine and report upon the cost-finding system of the Company. At this point Mr. Adam Bede, the Treasurer, entered the discussion; he expressed the belief that, since the company's own auditor had been away sick for a large part of the year, we should make some de-

"The right of third parties to rely on the apparent authority of corporate officers is subject to the condition that such third parties have no knowledge of a limitation on such authority. In this case we think the notice given the accountant that the audit . . . was for (the president's) personal account . . . was notice to the plaintiff."

In another case (*Respass et al. v. Rex Spinning Co.*, 133 S. E. 391) the auditors were appointed at a stockholders' meeting; a detailed audit was made, and the results were presented and explained to the stockholders. The company refused to pay on the ground that the directors had not approved the appointment; the decision was in favor of the auditors, the court saying in part:

"They made a detailed audit covering a certain period; they presented and explained their audit to the stockholders in a meeting subsequently held upon notice duly given; and their report was 'accepted as information' by the stockholders. With the resolution upon the minutes, this appropriation of the audit was a recognition of the alleged agreement; it was a ratification by the stockholders, even if the directors had not authorized the committee to act in the premises. As the contract was not ultra vires, it was not beyond the power of corporate ratification. By subsequent recognition it became as effectual and binding as if the committee had had undisputed power to bind the company; this on the principle that the company could not accept the benefit of the report and repudiate the agreement under which the report was made, or profit by the agreement and repudiate the authority of the agent by whom it was made. The ratification of an act by one who assumes to be an agent relates back, and is equivalent to a prior authority. The absence of some of the stockholders did not impair the force of the resolution. It has been held that, if an act is to be done by an incorporated body, the law, resolution, or ordinance authorizing it to be done is valid if passed by a majority of those present at a legal meeting."

tailed checks of the cash records. The main accounting records are kept at the plant at Elizabeth, and it was not deemed necessary for us to audit the sales offices except that we should make a surprise verification of the working funds at least once a year at those offices located in cities in which our firm has offices. The limitations of a balance sheet audit were discussed; it was agreed that we should make a survey of the company's system of internal check, including a detailed check of the cash transactions for two months (taken at random). It was finally agreed that for the first year's audit we should certify in short form a balance sheet and condensed statement of profit and loss. In addition we should present to the Directors a detailed report containing exhibits showing the sales by divisions, the cost of sales, and analyses of selling and administrative expenses, together with an outline of the verification work done; any criticisms of the present cost-finding system and any other explanatory statements or suggestions which we might consider advisable should be made a part of our detailed report.

Mr. Holt stated that we should probably not be required to render advice on income tax questions, or to assist in the preparation of the company's income tax returns. The Internal Revenue Department had examined the returns for previous years up to the close of 1925, and the small extra amount then assessed had been adjusted with the Government.

The question of the probable cost of the audit was then discussed. Mr. Bede stated that he was familiar with another business of approximately the same size which was audited annually by Messrs. Callout and Tickem for a flat fee of \$800; this firm also gave their clients each year a beautifully bound report of approximately fifty pages in length. We pointed out that for the first year at any rate, we could only undertake the work on a per diem basis of remuneration, but that subsequently we might be in a position to quote a maximum fee for future annual audits. Our usual per diem rates were quoted and explained, the total cost of the audit being estimated not to exceed \$2,000; it was finally agreed that for this year we should undertake the work on that basis.

Mr. Holt stated that the books would be closed tomorrow, Friday, and that we could begin work on Saturday. He desires that we complete the audit in time to be able to present our report for the regular monthly meeting of the Board of Directors to be held on Wednesday, December 19. It was accordingly arranged that we should begin the work at Elizabeth, N. J., next Monday morning (November 19). Mr. Sley stated that he would be glad to be informed, as the audit proceeded, of any special points for discussion; he assured us that we should receive the fullest cooperation of the company's staff in the prosecution of our work.

JCB/H (3)

(Initialed) J.C.B.

Discuss the appropriateness of the information included in the above memorandum; is any additional information desirable or necessary for beginning the audit?

PROBLEM 10

HUGHES, THORNTON & Co.

Questionnaire Regarding System of Internal Check

Messrs. Hughes, Thornton & Co., Certified Public Accountants, 231 South La Salle Street, Chicago, with offices in twenty cities in the United States and Canada, have developed a somewhat elaborate questionnaire to be used by assistants on auditing engagements in determining whether or not the client has a satisfactory system of internal check. This questionnaire is considered as a supplement to and not a substitute for, the Federal Reserve bulletin of April, 1917, "Approved Methods for the Preparation of Balance Sheet Statements."¹ In preparing the questionnaire the firm was guided, to a considerable extent, in its practical usefulness; while additional questions could readily be introduced, it was felt that from a practical standpoint the questionnaire was sufficiently comprehensive and should be helpful in developing points that might otherwise not be brought to light in the rush of the regular busy season.²

The complete questionnaire is as follows (space having been allowed opposite the questions for the answers) :

QUESTIONNAIRE RE SYSTEM OF INTERNAL CHECK
(For use on balance sheet audits)

The scope of a balance sheet audit as defined in the Federal Reserve Bulletin of April, 1917, comprises a verification of the Assets and Liabilities as of a certain date, a general examination of the Profit and Loss Account for a period ending on that date, and incidental thereto *an examination into essential features of the accounting, i.e., the system of internal check*. There is reason for believing that the latter requirement has not always received the attention it deserves and the following ques-

¹ The new bulletin, "Verification of Financial Statements," which appeared in May, 1929, as a revision of the April, 1917, bulletin, will automatically supersede the former publication.

² Attached to the questionnaire was a memorandum outlining the procedure to be followed in verifying cash and bank balances, particularly where an adequate system of internal check was not maintained; this memorandum follows:

"To the Members of the Staff:

"We think it well to call the attention of our staff to the fact that, in organizations where an adequate system of internal check cannot be maintained by reason of the smallness of the organization, our examination into the cash transactions, particularly the verification of the cash and bank balances at the close of the period under audit, should be conducted in a careful and painstaking manner and that the limited verification as outlined in the

tions have been prepared partially to correct this weakness. It should be borne in mind, however, that the questions are more suggestive than exhaustive and are, of course, not precisely applicable to every balance sheet audit.

The majority of the questions will be found to be answerable from observations actually made during the course of the work *and should be answered by the assistant doing the particular section of the work to which the questions apply.* If the assistant is unable to answer the questions on the work assigned to him it is evident that a careful and thorough verification has not been made.

Federal Reserve Bulletin of April, 1917, should be extended. We have, accordingly, prepared and are attaching hereto a memorandum outlining the procedure to be followed in connection with the verification of the cash and bank balances and it is requested that the schedules containing particulars thereof should show clearly the extent of the verification effected. Where bank practice does not permit of an exact adherence to the methods outlined (as in New York), the verifications should be of a character substantially equivalent.

HUGHES, THORNTON & Co.

MEMORANDUM REGARDING VERIFICATION OF CASH AND BANK BALANCES IN CONNECTION WITH SO-CALLED BALANCE SHEET AUDITS

"In verifying the cash the following procedure should be adopted, viz.:

"(1) The cash on hand, in so far as circumstances permit, should be counted promptly at the close of business on the last day of the month of the period covered by the audit.

"(2) In the event that the cash is not counted at that time it may be necessary when it is actually counted to make a supplementary and simultaneous verification of the bank balances.

"(NOTE: This applies particularly to companies not having a petty cash fund under the imprest system.)

"(3) Items other than currency and coin must be listed in detail and the nature thereof properly described in the working schedules.

"(4) Checks and vouchers supporting disbursements and held in lieu of cash must be listed and full particulars regarding the date of the check and voucher and names of payee and payer embodied in the schedules.

"(5) Receipts from employees for advances or any other items should be listed in detail with dates.

"(NOTE: The items listed under (4) and (5) should be presented to a responsible official of the company for his approval.)

"(6) The cancelled checks returned by the bank during the last month of the period should be compared with the entries in the cash book, i.e., name of payee and amount of check, while checks dated prior to the closing month should be compared with the previous reconciliation prepared by the client. The indorsements on the checks must be scrutinized; and where indorsements exist other than those of banks and the payee, inquiries should be made to determine whether or not irregularities exist in connection with such unusual or irregular indorsements. Before the completion of the audit the outstanding checks which form part of the bank reconciliation should be obtained from the bank direct and compared with entries in the cash book.

"(7) Outstanding checks not examined at previous audit on account of not being cancelled and returned by the bank before completion of work should be inspected and traced to the cash book entries.

"(8) In cases where the system of internal check in force is weak the cancelled checks for some other month than the last month of the year should also be examined and compared with the disbursements recorded in the cash book.

"(9) Currency checks for other than petty cash disbursements should be inquired into and tested by examination of supporting documents. A list of such checks and the account to which expenditure has been charged should be prepared for official's approval.

"(10) Any erasures on a check, indistinct indorsements or other suspicious features should be carefully inquired into.

"(11) Securities or negotiable instruments should be examined simultaneously with cash count.

"(12) Cash receipts (daily) for at least the last month of the period should be traced to the bank statement.

"(13) In cases where the internal check is weak a comparison of the collections recorded in the cash book should be made with the original deposit slips on file at the bank or with copies thereof obtained direct from the bank for a period of at least ten days prior or subsequent to the close of the period.

"NOTE: If any suspicious circumstances develop during the course of the examination they should immediately be called to the attention of a principal of the firm or to the manager in charge of the work. This should be done by the assistant before the matter is discussed with the client."

In cases where the direct method of interrogation is used, the questions should be taken up with the Comptroller or other responsible officials of the Company and a note made as to the source of the replies.

The questions under each section should be answered during the progress of that part of the work and while the matter is fresh in the mind of the assistant.

If this method is adopted it will be found that the questionnaire is not at all burdensome, and that it requires comparatively little time.

In cases where the name of an employee is asked, his position (when not evident from the question) should also be stated.

In filling out questionnaire you should not only ascertain that the necessary safeguards for purposes of internal control are provided, but you should also be able to say definitely from observation, inquiry and tests during the course of the examination that the prescribed procedure is being observed.

Name of Company }
whose records were examined }.....

Cash:

- (1) What duties other than the keeping of the Cash Records are attended to by the Cashier?
- (2) Does the Cashier have access to any of the ledgers?
- (3) To whom is the Cashier directly responsible?
- (4) What officers and employees have authority to sign checks?
- (5) Are the checks countersigned and, if so, by whom?
- (6) Are vouchers and supporting documents presented to officials for inspection simultaneously with the checks presented for signature?
- (7) Are supporting documents impressed with paid stamp or other distinctive mark so as to prevent the presentation thereof for duplicate payment?
- (8) Do officials at any time sign blank checks for emergency use during their absence?
- (9) What disposition is made of spoiled or voided checks?
- (10) Are cash receipts deposited intact daily?
- (11) Are the bank accounts reconciled regularly?
- (12) Who reconciles the bank accounts and does employee preparing or approving checks effect or have supervision over bank reconciliations?
- (13) How often is the cash audited? By whom?
- (14) Did you investigate any checks which have been outstanding for over one month?
- (15) Was Cash Book closed on last day of period or were checks mailed subsequent to that date entered on or prior to the closing date or cash received subsequent to that date recorded as received prior to last day?

- (16) How are cash sales handled?
- (17) Are checks issued payable to currency? If so, for what purpose, and is there any reason why the issuance of currency checks should not be discontinued?
- (18) Who opens the mail?
- (19) Is an independent record of incoming remittances prepared for comparison later with the collections recorded by the Cashier and, if so, is the comparison made, and by whom?

Petty Cash:

- (1) What position is held by the custodian?
- (2) Is imprest fund system in use?
- (3) Has Company established a maximum figure to be paid from fund?
- (4) Are all payments evidenced by receipts?
- (5) Did our count of fund disclose any unusual or exceptional items therein? If so, state schedule number on which these are listed.
- (6) If fund was partly composed of advances to employees were they approved by an official?
- (7) Were any post-dated checks included? Were other checks deposited immediately?
- (8) How often does custodian balance his cash?
- (9) How often is the Petty Cash audited and by whom?
- (10) Are receipts or documentary evidence supporting disbursements cancelled in such a manner as to preclude the use thereof in support of fictitious disbursements?

Payroll:

- (1) From what records are payrolls prepared?
- (2) Is time clock system in use?
- (3) Who prepares payroll?
- (4) By whom is it checked?
- (5) By whom is payroll approved?
- (6) Are employees paid by check or cash?
- (7) Is distribution of pay envelopes made by employee preparing or checking payroll?
- (8) Are authorizations for increases kept on file?
- (9) Who authorizes increase in number of employees?
- (10) If checks are used, is Bank Payroll Account reconciled regularly?
- (11) Did we audit last reconciliation of period?
- (12) Do employees sign the payroll or give receipts?
- (13) How are unclaimed wages dealt with?

Accounts Receivable:

- (1) What other office duties has the ledger keeper?
- (2) Are customers ever charged in advance of shipment?

- (3) If previous answer is affirmative what account is credited?
- (4) Are any balances carried as Accounts Receivable other than trade accounts?
- (5) Are consignment balances carried in Accounts Receivable Ledgers? If so, on what basis are charges made?
- (6) Are we to circularize the trade debtors?
- (7) Are we to mail the Company's own circularization after checking with balances at the close of the period?
- (8) Are regular monthly statements sent to customers?
- (9) Who prepares statements?
- (10) Who mails them?
- (11) Are bad debt write-offs officially authorized?
- (12) What control is exercised over bad debts after they have been written off?
- (13) Who authorizes cash and trade discounts and other allowances?
- (14) Who passes upon credit terms and limits?
- (15) Does ledger sheet show credit limit or what record is kept of it?
- (16) In verifying trial balance did you observe any accounts in excess of credit limits?
- (17) Has excessive credit been extended to any customers? If so, were there any unusually large balances contained in the outstanding at the end of the period under audit?
- (18) Are Customers' Ledgers regularly balanced with Controlling Accounts?

Notes Receivable:

- (1) Who is custodian of notes?
- (2) Who holds underlying collateral (if any)? What schedule shows detail?
- (3) Is value of collateral less than balance due on note?
- (4) Does cashier indorse partial payments on back of note?
- (5) Are notes ever renewed? By whose authority?
- (6) If notes are discounted what procedure is adopted by Company in effecting renewals? Does Company exchange checks with its debtor for the purpose of maintaining payee's credit at bank where note is discounted?
- (7) Are notes on hand balanced regularly with Controlling Account and by whom?

Securities:

- (1) Who is custodian of securities?
- (2) If securities are not in name of Company are they properly indorsed?
- (3) Are purchases and sales authorized in minutes?

- (4) Does cashier indorse partial payments on back of note?
- (5) Were letters obtained from Insurance Companies in confirmation of (a) surrender values of life insurance policies and (b) probable refund on Mutual Fire Insurance policies?

Capital Expenditures:

- (1) Are these authorized? How?
- (2) Is record kept of amounts expended in excess of or under authorizations?
- (3) Are physical inventories taken of movable equipment and tools?
- (4) How are discrepancies therein dealt with?
- (5) Have liabilities been taken up for all construction work completed up to end of period under audit including percentages withheld under contract?
- (6) How is surplus equipment disposed of and on what authority?
- (7) Has Company any unimproved land, idle plants or extra facilities?
- (8) Does Company intend to abandon or demolish any properties?
- (9) Are there any important contractual obligations in respect of plant additions and extensions? If so, what is probable total cost of work remaining to be completed and how is expenditure financed?

Liabilities:

- (1) Are Bankers' Loans authorized in Directors' Minutes?
- (2) Are loans secured by pledge of Company's assets or by personal indorsement?
- (3) Who has authority to sign Notes Payable and Acceptances?
- (4) How many signatures are required?
- (5) Are monthly statements received from trade creditors?
- (6) Were such statements compared with balances shown in Accounts Payable Record?
- (7) Is record kept of Contingent Liabilities?
- (8) Is record kept of all claims made against the Company?
- (9) Are trade creditors' accounts secured?
- (10) Are any provisions necessary in respect of losses arising from purchase and sale commitments?

Purchases:

- (1) Are purchase orders executed in writing?
- (2) Are invoices approved as to prices, description, etc., by Purchasing Department?
- (3) Are invoices sent to Receiving Department?
- (4) Are receiving tickets issued by receiving clerk without knowledge of merchandise orders?
- (5) In what department are receiving tickets matched with invoices?

- (6) In the event of merchandise being purchased for direct shipment to Customers is reference to sales invoice shown on purchase invoice?
- (7) By whom is this reference supplied?
- (8) Are receipts of merchandise recorded on Purchase orders to prevent duplicate payment on over-shipment?
- (9) Has Company filed any claims during period against Carriers for shortage or damaged material? If not, how are shortages, etc., handled?

Loans to Officials and Employees:

- (1) Are these authorized? By whom?
- (2) How are the loans evidenced?
- (3) Are they adequately secured?
- (4) Are they interest bearing?
- (5) Were any loans paid at close of period and again advanced shortly thereafter?
- (6) In what ledger are officials' and employees' balances recorded?

Stocks of Stores and Materials:

- (1) Are these under control of a storekeeper?
- (2) Are deliveries or departmental transfers made *only* on requisition?
- (3) If stock records are maintained do they reflect money values and quantities?
- (4) If stock records are in use, how and when are they adjusted to agree with actual quantities on hand?
- (5) How are discrepancies treated when disclosed?
- (6) Did you observe any substantial stock record adjustments?
- (7) Did you make test comparisons of quantities shown on inventory sheets with stock records?
- (8) Did your inspection of stock ledgers disclose any inactive or slow moving stocks?
- (9) Did you satisfy yourself that inventory values were below prices actually realized subsequent to closing date?
- (10) Does Company receive stock on consignment?
- (11) Does Company ship stock on consignment?
- (12) What record is kept of consigned stocks?
- (13) Who determines that stock is obsolete or slow-moving?
- (14) What disposition is made of obsolete or slow-moving stock?
- (15) Who determines the value at which obsolete or slow-moving stock is to be included in inventory?
- (16) Did you make any inquiries of storekeepers or other employees responsible for stores records (other than the officers or officials in the accounting department) as to obsolete or slow-moving stock?

- (17) If as a result of the foregoing inquiry certain stocks appeared to be obsolete, are particulars thereof, as well as the probable realizable value thereof, contained in the Inventory Schedule?

Sales:

- (1) On what authority are shipments made?
- (2) If made on other than shipping order, what record is sent to office?
- (3) Who receives record?
- (4) What disposition is made of it?
- (5) To whom is Shipping Department's copy of shipping order sent when shipment is made?
- (6) How are back orders handled?
- (7) What record is maintained of shipments which have gone astray?
- (8) Has the Company developed any new lines of merchandise which may have a bearing on the business formerly conducted?
- (9) Has Company abandoned any line of manufacture, and if so, for what reason?

General:

- (1) In what department is mail opened? By whom?
- (2) By whom is its disposition determined?
- (3) Is incoming mail registered?
- (4) Do mail remittances usually consist of checks?
- (5) If remittances consist also of currency or money orders what safeguard does Company adopt to insure proper accounting therefor?
- (6) Are employees in position of trust bonded? Do amounts of bonds appear adequate?
- (7) Do employees in position of trust take regular annual vacations?
- (8) Are their duties then assumed by other employees?
- (9) Does similar system to above obtain at the branches not visited by Hughes, Thornton & Co.?
- (10) Who audits such branches? How often?
- (11) Are written reports made of such audits?
- (12) Has the permanent file been brought up to date?
- (13) Have any new or unusual features or departures from the Company's previous practices or policies been observed during the course of the recent audit which have heretofore not been disclosed?
- (14) Does surplus balance contain any items of appreciation? If so, particulars thereof must be embodied in Working Papers.
- (15) Are our audit adjustments taken up on books of Company?
- (16) Outline Company's organization showing each department and to whom it is responsible.

- (17) What procedure is followed to assure Company that all shipments are represented by Invoice or Debit Memo?
- (18) What procedure is followed to assure Company that all Invoices or Debit Memos are charged on books to Personal Accounts?
- (19) Is amount to be expended for Replacements and Renewals specified in Authority for Capital Expenditure?
- (20) Upon whose authority does Purchasing Department order Raw Materials and Supplies?
- (21) How are returned goods accounted for on the Company's records, both as to stock records and Customers' Accounts?

Signature of	As to
Assistants in	Pages
charge of work	_____to_____
.....	_____to_____
.....	_____to_____
.....	_____to_____
.....	_____to_____
Date	

Study the above questionnaire, and consider the answers that should be made to the various questions if the system of internal check, together with certain tests and specific verifications on the part of the auditor, is to afford to the client a reasonable protection against defalcation or other manipulation of the accounts. Are there other essential questions which you believe should be asked? If so, what? Give your reasons for approving or disapproving the various sections, and the questionnaire as a whole.³

PROBLEM 11

THE BREMOND ICE COMPANY

Sufficiency of System of Internal Check

You have been employed by The Bremond Ice Company to audit its accounts for the fiscal year ended December 31, 1928, and to certify its accounts for the benefit of stockholders and others interested in the affairs of the company. As this is the first time that the company has had an audit made by independent accountants, you spend some little time discussing with the client the amount of verification work to be done; the client is

³ See also Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 67-77; Eggleston, *Auditing Procedure*, pp. 19-20, 298-299, 409-411; Bell, *Auditing*, pp. 81-84.

eager to have as little detail work done as possible, and yet desires that you satisfy yourself as to the accuracy of the accounts. You inform the client that subject to satisfying yourself as to the sufficiency of the system of internal check—which in combination with a balance sheet audit and reasonable tests will afford him substantial protection against the risk of defalcations—you believe that a balance sheet audit, as defined by the Federal Reserve Board, would be most satisfactory.¹ You accordingly proceed with the audit, taking up first the question of the company's organization and system of internal accounting; you obtained the following facts:²

General Organization

The Bremond Ice Company had virtually a monopoly of the ice business in one of the largest cities in the United States. The company had approximately 75,000 customers on some 200 routes; these routes were divided into seven divisions, each division being under the supervision of a manager, and each with an ice-house and delivery facilities. There were approximately 30 routes to a division, and between 300 and 350 customers on a route. In each division were four foremen, who were in charge of about eight routes apiece; these foremen not only kept the time

¹ The Federal Reserve Board defines a balance sheet audit as comprising "a verification of the assets and liabilities, a general examination of the profit and loss account, and, incidental thereto, an examination of the essential features of the accounting." See "Approved Methods for the Preparation of Balance Sheet Statements."

² Generally in practice these matters and others which are of continuing importance to the auditor, would be recorded in the permanent-file papers. The components of a model permanent file would include the following:

1. Copy of memorandum of client's instructions, and notes of any alterations therein.
2. Copy of certificate of incorporation (or articles of copartnership) and any subsequent amendments.
3. Marked copy of the by-laws, and any subsequent amendments.
4. Marked copies of any trust deeds relating to funded debt (or a synopsis of the points affecting the accounts).
5. Abstracts of minutes, arranged chronologically, and with points of continuing importance indicated.
6. Synopses of contracts of current importance.
7. Copy of opening journal entries and supporting data.
8. If the company has subsidiary or related companies, a chart of these relationships may well be included.
9. The card of accounts, and a brief description of any unique points in the accounting system.
10. Copies of any forms used in the accounting and cost departments which are of substantial importance from an auditor's point of view.
11. Chart of the personnel, with duties of each (especially of the accounting and auditing departments).
12. Annual questionnaire with reference to system of internal check.
13. Historical summary in columnar form showing the yearly additions to the following accounts (or groups of accounts): Goodwill, properties, depreciation reserves, capital, funded debt, important adjustments to surplus, net profits before income taxes, income taxes, dividends, etc.
14. Perennial plan of audit with approximate time spent on the work.

of the drivers and helpers, but also traveled about their routes in order to see that the drivers did not "loaf." Each division had a superintendent who kept the time of all the yard employees, and was responsible for the general maintenance of the divisional delivery facilities.

The general manager of the company was responsible for all ice deliveries, employment, and the payroll. The treasurer was responsible for all collections from the divisions and for all payments; the chief auditor, assisted by four internal auditors, superintended the keeping of the accounting records. The purchasing agent authorized all purchases, supervised all inventories, and had authority to declare equipment obsolete. Each division manager served as credit manager for his division; each customer who wished to open an account was required to furnish two references, but the division manager usually granted credit without investigating either of them. The loss from bad debts had rarely exceeded 3% of net sales.

The accounting department of the central office kept the general ledgers; each division, however, had an accounting department, which kept the subsidiary accounts receivable ledgers, the payroll, the divisional cash book, and the petty cash book. Each division deposited its cash receipts daily in a near-by bank designated by the company; all withdrawals from these banks were made by the central office upon checks signed by the treasurer and countersigned by one of the directors.

Cash Receipts and Disbursements

The company allowed drivers to accept cash in payment for ice deliveries, but discouraged that and employed special collectors. Each day the driver gave the money collected from cash sales to a clerk in the division office who counted the money, recorded it in the cash book, and credited the driver's account with the amount the following morning. The clerk deposited in the bank daily the cash received from all drivers; the bank sent a duplicate deposit slip directly to the central office.

For customers who had weekly contracts, collectors made out the bills and collected payments which they delivered to the division office each Monday afternoon. A clerk in the division

office counted the cash, credited the amounts to the respective collectors' accounts, and deposited the money Tuesday morning. From the deposit slip a bookkeeper made the proper entries in the cash book; a duplicate deposit slip went directly to the central office. For the monthly, seasonal, and annual accounts invoices were mailed to the customers, or collectors called for the payments; in the latter case the records were made as for the collections arising from the weekly accounts.

Disbursements for all expenses, including payrolls, incurred by any of the seven divisions were made by check from the central office. In the absence of the treasurer one of the directors was authorized to sign checks, but these checks were not valid unless countersigned by another director. The company maintained checking accounts with each of the division banks, and usually drew checks on the bank with the largest balance. From the duplicate deposit slips and the records of checks drawn, the accounting department of the central office prepared monthly reconciliations with the bank statements.

The imprest fund system of petty cash was used in each division; a petty cash book was used to record all disbursements made by the division. Sundry supplies were purchased from the division petty cash fund. Also when employees wished to be paid before pay day they were advanced money out of the petty cash fund; their signatures in the petty cash book served as the receipt. When the payroll was made out it was prepared for the full week's wages, and the petty cash fund replenished from it for the advances made.

Since the majority of the employees of the company were either directly responsible for the collection of cash, or handled it, all drivers, collectors, and office employees were bonded by an indemnity insurance policy which included all of these positions. The bonds were graded to correspond with the amount of cash handled by the different groups of individuals.

Because of the large number of customers and the large number of collections, the company's internal auditors bi-monthly checked the entries in the subsidiary accounts receivable ledger and in the divisional cash books. They also prepared the recapitulation sheets of the divisional subsidiary ledgers, from which the

entries to the accounts in the company's general ledger were made. These latter sheets were prepared monthly, and were sent to the central office at the end of each month. All general and subsidiary ledgers were bound books, but loose-leaf books were used for these recapitulation sheets.

Responsibility for Ice

The division manager was responsible for all ice and equipment in his division. An annual physical inventory was taken on January 1st by the yard employees of the division; this was compared with the book inventory. The purchasing agent was notified of any discrepancies and his approval received in order to make adjustments in the book inventory. The perpetual inventory of ice was kept by debiting the account for ice received and crediting the account for ice delivered and for shrinkage. Over a period of years the company had found that the average shrinkage of ice was approximately 5% in the ice house and 10% in the wagons. The shrinkage of ice in the ice house was credited at the time of taking the inventory, but shrinkage of ice on the wagons was credited each time a driver returned to the division. Ice unaccounted for in sales and returns was regarded as shrinkage.

The driver on each route was responsible for all ice loaded on his wagon. Before he left the division ice house with a wagon-load of ice, the ice was weighed and a charge made against his account in the drivers' ice book. Upon his return he was credited with the ice which he still had in his wagon. Each driver was allowed 200 pounds shrinkage per ton of ice, because of the waste in cutting it and the natural loss from its melting. When the price of ice was 50 cents a hundred-weight, the driver should have returned \$9 in cash or the equivalent in credit sales for each ton of ice charged to him. The entries in the drivers' ice book were as follows:

<i>Debits</i>	<i>Credits</i>
Ice booked	Cash returned Tickets returned or charges made Ice returned Allowance for melting

Employment and Payrolls

Each division manager hired and discharged employees in his division. When he made a change in the personnel, he notified the general manager at the central office. Each Monday morning, from the timekeeping records turned in by the superintendent and foremen of each division, the division payroll clerk prepared in duplicate a payroll requisition which the division manager signed. The division manager kept the duplicate requisition; the original was sent to the general manager, who approved it and sent it to the treasurer. The treasurer drew a check for the total amount; this check was forwarded to the division manager, who cashed the check and filled an envelope for each employee.

The payroll clerk did the actual paying off on Wednesday, and was assisted by one or two of the division office employees. Each employee was required to sign a receipt for his envelope, stating the date, the amount he had received, and his name. When employees were unable to call for their own envelopes, friends were allowed to obtain them and sign receipts—provided the employees had given written permissions. When employees were sick, the foremen often signed receipts for the envelopes and delivered them to the employees. In such cases the foremen obtained from the employees receipts which the foremen returned to the division office to replace their own receipts; the latter were then destroyed.

The division office kept unclaimed wage envelopes for a week, and then sent them to the treasurer who deposited the funds. The amounts so deposited were debited to Cash and credited to Profit and Loss. Since wages were rarely unclaimed, the company had never adopted any other procedure for accounting for unclaimed wages.

The Accounts Receivable

The Bremond Ice Company kept five kinds of accounts with customers—annual, seasonal, monthly, weekly, and coupon. The company maintained yearly contracts with a large number of offices in the business district of the city; by these contracts the company agreed to deliver definite quantities of ice on specific days throughout the year. The division billed these customers

January 1. Many professional offices, which desired ice only from May 1 to October 31, opened seasonal accounts; the division billed them on November 1.

The majority of the accounts were monthly. For customers with such accounts the driver recorded the amounts of ice delivered, the record being made on a card which hung near the customer's ice box; these cards the driver collected at the end of each month. Upon the driver's return each day to the division office he entered, from memory, in the customers' book the amount of ice delivered to each customer. At the end of each month the customers' cards were compared with the amounts in the customers' book, but the bills were made out from the book. If a customer complained of an overcharge the company accepted the record on the customer's card in making adjustments. Reimbursements to customers for overcharges were credited to Accounts Receivable and debited to Sales.

The general manager believed that this system was employed generally by other ice companies. Since men served an apprenticeship as helpers before they were made drivers, they became thoroughly familiar with the customers on their routes and knew about how much ice the different customers were accustomed to take, so that entering from memory the amounts delivered was probably not so inaccurate as might first appear.

The system used did not prevent the customer from changing the figures on his ice card but no instance where this had been done had ever come to the attention of the company. Customers occasionally sent their payments to the central office; in this case a clerk in the central office recorded them in a collection book, and each morning made out a list of such payments which he sent to the division from which the bills were originally sent. One clerk in the division office made the records of cash received, and another clerk posted the credits to the customers' accounts.

Collecting the Weekly Accounts

Each division usually sent weekly bills to customers who took 1,000 pounds of ice or more a week; such customers were also supplied with ice cards. Each division employed several collectors who visited these customers every Monday and were instructed to collect cash for the total amount of the weekly bill.

In many cases the collectors were lax and allowed the bills to accumulate for as long as six weeks; from time to time the treasurer had requested the collectors to be more rigid, but even that had not had the desired effect. The treasurer had instructed the division offices not to allow credit for more than three weeks to customers with weekly accounts, or for more than three months to customers with monthly accounts. The division office notified the central office when accounts reached these limits, but the central office frequently made exceptions and had no definite mechanism to stop allowing credit to a customer. Very few accounts had to be written off to Profit and Loss each year, but the treasurer believed that a more rigid adherence to credit limits should be maintained so that customers who were supposed to pay weekly or monthly would do so.

On January 1, 1925, in order to find out when collectors had been lax and also to verify customers' accounts, the company introduced a checking slip to send to customers. This slip showed the amount of the customer's indebtedness as shown by the books of the company. The customer was requested to return the slip after he had entered at the bottom the amount which his books showed that he owed the company. The slip stated that it was not a request for payment; because of this the company believed that the system would not cause any complaints from customers. It would have cost too much to have sent these checking slips to all customers, so approximately 200 accounts were selected at random from each division each week. Generally overdue accounts were selected, and care was taken not to send checking slips to the same customers two weeks in succession. The company followed the practice of adjusting the accounts to correspond with the amounts which the customers stated they owed.

The Coupon Accounts Receivable

In one division in which deliveries were made to a large number of apartment houses it was not possible for the driver to remember to whom he had made deliveries. Consequently, the division had introduced the use of coupon books for all customers. These books ranged from those which contained coupons exchangeable for 500 pounds of ice to those for 10,000 pounds. The coupons in the "500-pound books" were of 5, 10, and 25-

pound denominations; in the "1,000-pound books," 5, 10, 25, and 50-pound denominations; and in the "3,000-pound books" the principal denominations were 50 pounds, with a few coupons for 5, 10, and 25 pounds each. Nearly all coupons in the "10,000-pound books" were for 100 and 200 pounds. Each morning before leaving the ice-house the driver received several coupon books, and these he sold to customers as required; the driver's account was charged with the value of the books which he took. In the front of each coupon book was a receipt which, when the book was sold, was torn out and signed by the customer; the driver returned these receipts to the division office in order that he might be credited for the coupon books that he had distributed. When ice was delivered, the driver collected coupons to correspond with the weight of the ice delivered; upon his return to the office he turned in his coupons in order to help account for his ice.

In this division the accounts receivable were kept on ledger cards. Debit entries to these cards were made from the drivers' receipts, and bills for the entire value of the coupon books were made out immediately and sent to the customers the first thing the following morning. Most customers paid these bills promptly, but a few waited until the first of the following month. Drivers were instructed not to deliver a second coupon book until the first had been paid for, but occasionally two or three books were delivered before the customer made payment; it was difficult for the drivers to be sure whether or not payment had been made.

Since the majority of the books were paid for as soon as billed, the company always had outstanding a considerable number of coupons which the company was bound to redeem either in ice or in cash. In spite of this liability, however, the company considered a coupon book when sold as ice delivered, and classed the customers' cards as Accounts Receivable.

It would have been almost impossible for the division to have an account of the unredeemed coupons of each customer; it might have been possible, however, to have an approximate record of the total coupons outstanding and unredeemed. When the drivers returned their coupons at the end of the day a clerk sorted them by routes, and totaled them on an adding machine; from these totals the various drivers' accounts were credited in the drivers' ice book.

Annual Analysis of Customers' Accounts

At the close of each fiscal year the company's internal auditors visited each division office, and made an analysis of the customers' accounts to determine which amounts they considered uncollectible. A list of these accounts was submitted to the treasurer, and, subject to his approval, these doubtful accounts were transferred to Doubtful Accounts Receivable; the detailed subsidiary accounts were segregated in the back of the Accounts Receivable ledger. Over a period of years most of the doubtful accounts had been paid. The payment of such an account was treated as though it were a current account; the debit was to Cash, and the credit in both general and subsidiary ledgers to Doubtful Accounts Receivable. No general reserve for bad accounts was provided.

The company did not encourage customers to use notes in the payment of accounts; in unusual circumstances, however, the treasurer occasionally accepted notes. When notes had been accepted, no collateral had been required, and all notes had been paid at maturity.

General

The division office bought sundry supplies from petty cash, but made requisitions to the company's purchasing agent for expenditures requiring larger amounts. The purchasing agent entered all purchase requisitions which he had approved in a purchase book with separate pages for each division. When he received notification that purchases had been received by the division, he approved an accounts payable voucher as prepared by the accounting department, and forwarded it to the treasurer's office for payment. In order to make certain that these payments had been made, and that the voucher corresponded with the proper entry in the purchase requisition book, one of the internal auditors checked the purchase book with the cash book at the end of each month.

The general manager, after making inspections, reported to the purchasing agent whenever he considered equipment obsolete. The purchasing agent had sole authority to declare equipment obsolete.

Profit and loss statements were prepared by the accounting

department, and submitted monthly to the board of directors. Allowance was made each month for accrued wages, interest, insurance, and taxes, but no provision was made for sales allowances or uncollectible accounts because of the clerical labor involved in making proper analysis of these. While the error resulting from this might vary from month to month, the executives believed that this difference did not distort seriously the monthly Profit and Loss Statement.

Is the system of internal check sufficiently satisfactory that you may proceed with a balance sheet audit? ²

PROBLEM 12

THE EAT-WELL CEREAL AND BISCUIT COMPANY

Suggested Audit Program for Branches and Subsidiary Companies

The Eat-Well Cereal and Biscuit Company is located in St. Louis, Missouri, and has branches located in various leading cities throughout the United States. The company also has certain subsidiary companies, engaged in furnishing raw materials or in producing allied products. The company's books and accounts are audited annually by a leading firm of certified public accountants, Messrs. Gay, Copperfield & Co., Boatmen's Bank Building, St. Louis, who also have offices located in leading cities throughout the country. The audit is handled from St. Louis, where all consolidated accounts are prepared for the client, but the various branch offices of the company are audited by the several offices of the accounting firm.

In order that the audit work will be as nearly uniform as possible for all the branches of the company, it has been customary for the supervising assistant in charge of the audit for Messrs. Gay, Copperfield & Co. to prepare a suggested audit program to be followed as far as practicable by the various offices of the firm which assisted in the audit. The instructions prepared by St.

² See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 67-77; Thompson, *Accounting Systems, Their Design and Installation*, pp. 146-207.

Louis and sent to its various offices for their guidance in the conduct of the audit for the year ended April 30, 1929, were as follows:¹

THE EAT-WELL CEREAL AND BISCUIT COMPANY

SUGGESTED AUDIT PROGRAM TO BE FOLLOWED AS FAR AS IS PRACTICABLE FOR THE YEAR ENDING APRIL 30, 1929

Property Accounts

Invoices or other documents should be seen for all additions to property accounts of \$100 or over. It is not necessary to examine in detail the smaller charges, but, should it be found that a large number of small charges appear in the property accounts, a memorandum should be placed on the bottom of the schedule containing the summary of the property accounts, stating the general character of such charges. All credits to property accounts should be examined and those representing dismantlements or sales should be carefully examined to see that they properly extinguish the original cost and that the relative provision for depreciation is properly eliminated from the reserve. The client will furnish a statement of debits and credits for the year for each property account. The leading property account schedule should be arranged or classified to dovetail into the property accounts as shown on the balance sheet.

Where no change has taken place during the year in a property account such as Land or Buildings, there is no object to be gained in using a sheet of analysis paper to state that fact, a notation on the property accounts summary against the balance being all that is required.² A certificate should be obtained from the officials covering the propriety of the capital additions and the question as to whether or not properties sold or abandoned have been credited to the property accounts.

Inventories

The extensions of all items of \$100 or over should be checked and the extensions of the smaller items tested. All footings should be checked to the nearest dollar. The basis of the valuation of the larger items in the Raw Materials, Packages, and Expense Inven-

¹ A skeleton balance sheet and leading working schedules, with the headings and other captions included, were also furnished to the branch offices of Messrs. Gay, Copperfield & Co., but because of their bulkiness these have been omitted in the presentation of the problem.

² For the form of such summary schedule see Jackson, *Audit Working Papers*, Appendix B, Exhibit 8.

tories should be checked with current invoices covering the purchase of the materials and any variation between invoice cost and market at April 30, 1929 should be noted. If the market price is found to be lower than the cost price used in the inventory, the difference should be calculated and such differences totaled and a notation thereof made on the inventory summary schedule.

On the left-hand side of the summary sheet should be entered the various inventory subdivisions or accounts, such as Raw Materials, Packages, Manufacturing Expenses, Oven and Furnace Fuel, Heat and Power Repairs, etc. Columns are headed as follows: Balance per Ledger April 30, 1929, Raw Materials and Supplies, Finished Products and Merchandise, Deferred Charges, and Returnable Packages, the amounts in the Balance per Ledger column being distributed into the four other columns. One additional column should be used in cases where market is lower than invoice cost, in which will be entered the amount of the differences as calculated and totaled for each section of the inventory.

Should errors in footings or extensions, or actual errors in pricing, be found, the difference arising from the corrections of such errors should be taken up in the books at once as it is neither necessary, nor desirable, to include on the summary a column for errors. Each of the inventory accounts appearing on the summary should be given a sub-number, being a reference to the sub-schedule upon which the details of such inventory should appear.

In the verification of the pricing of cereal products, cereal merchandise, and other merchandise inventories, comparisons should be made with the company's published list prices. Schedules should be prepared showing the classification of each of these inventories with columns headed as follows: Value at List, Percentage Deducted, Amount Deducted, and Company's Inventory Value. The purpose of this percentage deducted from list is to reduce the cereal inventories to cost or approximate cost. It has been invariably found in the past that the company's deduction was not sufficient to reduce these inventories to cost, but the further adjustment necessary will be made at the head office and need not be attempted by the senior in charge of the branch audit.

The whole question of the verification of prices of the inventories should be very carefully supervised by the senior, who should himself list the items, the valuation of which is to be verified. Much time is needlessly lost by making long lists of minor items for price-testing which, when totaled, would be found to constitute but a small

percentage of the actual inventory value. The sub-schedule for the Inventory of Returnable Packages should show in summary form the various regular sizes of boxes, the number on hand of each size, the price at which each is carried in the inventory, the amount appearing in the inventory, the cost price of each size, and the amount extended at cost. This schedule should, however, form part of the property schedules since, for balance sheet purposes, the returnable packages are classified as "Properties."

It will be found by referring to last year's working papers that unexpired insurance is included by the company in its inventories. For balance sheet purposes the premiums unexpired are shown under the heading of Deferred Charges. A summary schedule only should be prepared showing the amount verified as unexpired insurance premiums classified according to character of insurance in force, showing also the amount of insurance in force.³ There should be attached to this schedule the certificates obtained from mutual companies.

Since the greater part of a branch inventory is finished product, the pricing can be readily tested by comparison with the company's published list prices. It should only be necessary, therefore, to make a general check of the other sections of the branch inventories for clerical accuracy unless the amounts involved are relatively large. Since it may be assumed that there is a normal ratio between the amount invested in inventories and the amount of a normal year's sales, it would be well to prepare a schedule showing, for the past three years, the amount of sales to customers, the amounts of the inventories, and the ratios which the inventories bear to the sales. Any unusual variations in the average ratios should be inquired into and the result of the inquiry noted on the schedule.

Accounts Receivable

The trial balances of the accounts receivable ledgers should be checked and agreed with the controlling account; a list of past due accounts will be furnished by the client and the matter of their collectibility should be discussed with the credit manager, notations as to the result of the discussion being entered opposite each item. Analysis columns should be used, headed Bad, Doubtful, and Good.

Other Current Assets

Securities representing miscellaneous investments should be examined and scheduled in the usual way, and cash in banks and on

³ A summary schedule similar to that called for here may be found in Jackson's *Audit Working Papers*, Appendix B, Exhibit 14.

hand reconciled or verified by certificates and by actual count, respectively. Schedules for outstanding checks in connection with the bank reconciliations will be furnished by the client and notations should be made opposite any large amount showing the date issued and to whom payable.

Deferred Charges

As previously mentioned, a considerable proportion of the deferred charges consists of items included in the inventories and reclassified for balance sheet purposes. Other deferred charges such as prepaid interest, bond discounts, etc., will be verified in the usual manner.

Inter-Company and Branch Accounts

The following is a list of the branches and affiliated companies, the accounts of which enter into the final consolidation:

Eat-Well Cereal and Biscuit Company of New York
Eat-Well Cereal and Biscuit Company of California
Central Office, St. Louis
St. Louis Bakery, St. Louis
Kansas City Bakery, Kansas City
Chicago Bakery, Chicago
Boston Bakery, Boston
Minneapolis Bakery, Minneapolis
Denver Bakery, Denver
Dallas Bakery, Dallas
Excelsior Candy Company, Chicago
Sleek Animal Food Company, Philadelphia

The company has informed us that every effort will be made to have the inter-company and branch accounts in agreement at April 30, 1929 so that no difficulty should be encountered in effecting the usual reconciliations.

Notes Payable

These should be verified in the usual way by correspondence with the company's bankers and other note creditors, the correspondence also containing a request for a statement of the collateral, if any, held as security against the loans.

Accounts Payable

Every effort should be made to ascertain that all unstated liabilities are included, and, in this connection, it is suggested that in-

voices received after the closing date be scrutinized; contracts under which partial shipments have been made to the company, and advices of goods shipped to the company f.o.b. shipping point should be inspected. It is also desired that a statement of purchase commitments for future delivery should be prepared showing the contract price to be paid upon receipt of the goods and the market price of the respective commodities as at April 30, 1929.

Profit and Loss Account

The company has an expense account under the name of "Rents, Insurance, and Taxes" and charges to this account comprise items applicable to (a) cost of manufacture, (b) selling and branch expenses, and (c) administrative expenses such as corporation franchise taxes, federal income taxes, etc. In order that the proper distribution may be made for the annual financial statements, this account will be analyzed by the client into the following heads: Rents, Depreciation, Federal Income Taxes, Fire Insurance, Property Taxes, Corporation Franchise Taxes, Water Rents, and any special items.

Balance Sheet and Profit and Loss Account Forms

Attached to this memorandum of instructions will be found a form of balance sheet which provides for both branch and inter-company assets and liabilities as per books. The balance sheet also provides a debit and credit column for adjustments which the senior in charge believes should be made, other than adjustments of inventory errors and such like, which should be entered upon the company's books and included in the final trial balance as per books.⁴ The *suggested* adjustments should be supported in the working papers by journal entries supplemented by complete explanatory notes. The final debit and credit columns on the balance sheet are to be left blank to enable the St. Louis office to take up such of the suggested adjustments as it considers necessary. In the form of the profit and loss account enclosed, one column is provided for the Branch Profit and Loss Account as per books, one column for the elimination of Inter-branch Sales, one column for suggested adjustments, and a final column for use by the St. Louis office.

Working Papers

Upon completion of the work at a branch, the working papers should be bound together, properly indexed, and forwarded with the

⁴ A form similar to that referred to will be found in Jackson's *Audit Working Papers*, Appendix B, Exhibit 7.

previous year's working papers by *first-class* mail to Gay, Copperfield & Co., St. Louis, which office should be notified by wire one day before the senior expects to mail the papers. Included in the working papers should be adequate notes dealing with the special features developed during the examination together with a list of any certificates still to come or any inter-company or inter-branch balances, verification of which has not been completed.

Discuss the above suggested audit program; is there additional information which you believe should be included? If so, what? Give your reasons.

PROBLEM 13

CHARLOTTE MILLS, INCORPORATED—PART I

Annual Audit for the Year Ended June 30, 1924

You have been retained as auditor of the Charlotte Mills, Incorporated, since the date of its incorporation, July 1, 1916. The company's fiscal year ends on June 30, and as soon as possible thereafter you take up actively the work of the audit; it takes the company's accounting department about one month to get its books and records in readiness for the audit. You have followed the practice, however, of going immediately at the close of the company's fiscal period to its main office to count the cash and to examine all securities and negotiable instruments on hand.¹ As a result of your work each year, you not only certify the company's balance sheet and relative income statement, but also submit in reasonable detail a report upon the audit.

The main financial and operating offices of the company are located in Boston, Massachusetts. The company manufactures cotton cloth of standard construction and of novelty styles, and sells it through selling companies located in New York. The company has mills in Arlington, Boston, Cambridge, Charlestown, Dorchester, Melrose, and Woburn. The accounting is centralized in the Boston office, each mill submitting weekly reports covering its operations.

On August 1, 1924 you begin the audit of the company for

¹ The detailed count of cash and the examination of securities, even though taking place at a date earlier than the actual entrance upon the audit, will constitute Part II of this problem.

the fiscal year ended June 30 and are presented with trial balances, prepared before closing the books, of the private and general ledgers. You have, in your previous year's working papers, the post-closing trial balances for these ledgers, and the final balance sheet for the year ended June 30, 1923 (both of which are presented herewith for your information). Since you have already satisfied yourself of the sufficiency of the system of internal check, you proceed at once with the balance sheet audit.

The comparative trial balances for the *private* and *general* ledgers are as follows:

CHARLOTTE MILLS, INCORPORATED
PRIVATE LEDGER TRIAL BALANCES

Folio	Account	June 30, 1923 after closing		June 30, 1924 before closing	
		Dr.	Cr.	Dr.	Cr.
1	Mill Properties	\$ 6,500,000.00		\$ 6,500,000.00	
3	Machinery, Equipment, etc.	12,500,000.00		12,500,000.00	
5	Additions to Plant . .	2,810,823.20		2,810,823.20	
9	Goodwill	1.00		1.00	
11	Accounts Receivable - Stock Subscriptions on Second Preferred Stock			505,000.00	
13	Inventories	3,954,637.22		3,954,637.22	
14	Inventory Reserves . .		\$ 296,524.00		\$ 52,120.60
15	Cash	500.00		500.00	
17	Organization Expenses .	127,650.42		127,650.42	
19	Discount and Commis- sion on Bonds	270,994.08		270,994.08	
20	Investments in Associ- ated Companies	300,000.00		300,000.00	
21	Other Investments . . .	126,542.30		154,726.75	
23	Notes Payable - Banks		5,500,000.00		4,300,000.00
27	Notes Sold through Brokers				1,000,000.00
30	Common Stock		12,654,725.30		12,654,725.30
31	1st Preferred Stock . .		1,000,000.00		1,000,000.00
32	2nd " "		1,500,000.00		3,000,000.00
33	1st Mortgage Bonds - 7%		5,000,000.00		5,000,000.00
34	Bonds Retired			125,000.00	
35	Surplus		1,176,134.86		990,747.01
41	Profit and Loss Direct .				9,500.00
52	Suspense		3,000.00		3,000.00
60	Reserve for Deprecia- tion		300,000.00		300,000.00
70	General Ledger Control	839,235.94		1,060,760.24	
		\$27,430,384.16	\$27,430,384.16	\$28,310,092.91	\$28,310,092.91

CHARLOTTE MILLS, INCORPORATED
GENERAL LEDGER TRIAL BALANCES

Account	June 30, 1923 after closing		June 30, 1924 before closing	
	Dr.	Cr.	Dr.	Cr.
FIXED ASSETS:				
Mill Structures			\$ 293,382.55	
Tenements			2,185.20	
Equipment			219,546.34	
Equipment Technical			350.07	
Machinery			430,262.14	
Transportation Equipment			4,000.00	
Furniture and Fixtures			542.20	
Land				\$ 7,000.00
CURRENT ASSETS:				
Cash - Banks	\$ 427,966.50		1,295,741.20	
" - Operating Office	1,000.00		1,000.00	
" - Mill Offices	1,900.00		1,900.00	
Cashiers Advances	360.00		185.00	
First Trust Co. - Trustee	20,500.00		7,000.00	
Accounts Receivable - Cotton Products Company	1,757,509.20		1,452,699.77	
Accounts Receivable - Textile Selling Corporation	1,601,030.51		542,100.20	
Accounts Receivable - Textile Foreign Export Corp.	10,779.62		3,457.90	
Accounts Receivable - Operating Office	23,957.91		15,654.20	
Cotton Claims	34,992.00		26,723.19	
Notes Receivable	4,530.00		4,290.00	
Mortgages Receivable	11,000.00		16,000.00	
* Alfred Johnston - Supt.	5,700.00		4,500.00	
* H. P. Bennett - Purchasing agent	2,600.00		2,000.00	
* Investments	22,000.00		16,500.00	
J. R. Hand Co. (Accounts Receivable in litigation)	4,265.20		4,265.20	
Cotton Purchases			3,955,647.39	
General Supplies Purchased			526,399.51	
Fuel and Fuel Oil Purchased			61,971.95	
Starch and Size Purchased			14,257.20	
DEFERRED ITEMS:				
Interest Prepaid	37,187.50		44,270.84	
Insurance "	31,654.90		32,527.20	
Container Acct.	1,220.00		1,564.00	
CURRENT LIABILITIES:				
Cotton Acceptances		\$ 218,650.20		239,540.20
Vouchers Payable		629,756.39		343,599.30
Accounts Payable - Cotton Products Company		120,695.73		57,927.10
Accounts Payable Textile Selling Corporation		62,941.20		33,717.39
Owed for Wages - Mills		97,657.84		110,819.20
" " - Others		920.50		1,415.00

* The starred items are notes receivable.

CHARLOTTE MILLS, INCORPORATED
GENERAL LEDGER TRIAL BALANCES (*Cont'd*)

Account	June 30, 1923 after closing		June 30, 1924 before closing	
	Dr.	Cr.	Dr.	Cr.
CURRENT LIABILITIES (<i>Cont'd</i>)				
Accrued Finishing Charges		\$ 9,276.51		\$ 8,247.71
Unclaimed Wages		1,726.32		2,057.16
Bond Interest Accrued		6,950.00		7,220.00
RESERVES:				
Reserve for Depreciation		1,844,279.81		2,308,234.91
Reserve for State and Local Taxes				6,813.09
Reserve for Federal Taxes		100,000.00		
Reserve for Bad Debts		30,000.00		30,000.00
Reserve for Cotton Claims		10,000.00		10,000.00
Reserve for Outstanding Checks		562.90		721.30
Reserve for Depreciation of Securities		27,500.00		27,500.00
SALES & RETURNS:				
Sales - Mill Products - Cotton Products Co.				6,150,127.72
Sales - Mill Products - Textile Selling Corp.				5,110,519.29
Sales - Mill Products - Foreign Export Corp.				109,710.11
Sales - Yarn				251,716.25
Sales - Miscellaneous				10,800.20
Returned Sales - Mill Products			\$ 126,940.32	
Returned Sales - Yarn			1,520.90	
OTHER INCOME:				
Interest on Mortgages				960.00
Interest on Notes				522.60
Interest on Bank Balances				5,490.39
Interest on Subscriptions				5,000.00
Cash Discount on Purchases				6,221.31
Rentals - Stores				2,000.00
" - Tenements			3,211.60	
MANUFACTURING EXPENSE:				
Arlington Mill - Wages, etc.			525,407.85	
Boston " - " "			1,196,726.59	
Cambridge " - " "			367,896.75	
Charlestown " - " "			279,542.23	
Dorchester " - " "			765,750.25	
Melrose " - " "			675,390.80	
Woburn " - " "			527,930.62	
Mfg. Ledger Undistributed			50,722.93	
Extraordinary Repairs			67,997.81	
Mfg. Exp. - Cost of Waste Sales			70,640.90	
Mfg. Exp. - Salaries of Supts.			48,210.20	
Mfg. Exp. - Engineering Dept.			4,110.00	

CHARLOTTE MILLS, INCORPORATED
GENERAL LEDGER TRIAL BALANCES (*Cont'd*)

Account	June 30, 1923 after closing		June 30, 1924 before closing	
	Dr.	Cr.	Dr.	Cr.
MANUFACTURING EXPENSE				
(<i>Cont'd</i>):				
Mfg. Exp. - Purchasing Dept.			\$ 620.90	
Mfg. Exp. - Provision for Depreciation			540,000.00	
Mfg. Exp. - Provision for State and Local Taxes			189,540.00	
Mfg. Exp. Transfers				\$ 520.00
OPERATING OFFICE EXPENSES:				
Salaries - General Manager and Assistants			46,940.30	
Salaries - Payroll Dept.			10,840.90	
Salaries - Cost Accounting Dept.			12,922.61	
Salaries - Engineering Dept.			27,936.72	
Salaries - Purchasing Dept.			6,530.90	
Salaries - Cotton Dept.			7,890.22	
Salaries - Welfare			4,000.00	
Salaries - Clerical			36,950.93	
Rent, Light, Heat, etc.			13,940.21	
Telephone and Telegraph			672.53	
Traveling			319.37	
Stationery and Printing			4,312.11	
Dues and Publications			3,954.86	
Auto Maintenance			2,864.92	
Insurance Expense			2,400.00	
Miscellaneous			3,540.79	
Expense - Payroll Dept.			329.70	
Expense - Cost Accounting Dept.			756.99	
Expense - Engineering Dept.			1,001.27	
Expense - Purchasing Dept.			997.25	
Expense - Cotton Dept. and Testing			765.90	
Expense - Welfare and Gratuities			21,940.20	
BOSTON OFFICE EXPENSES:				
Group Insurance			754.90	
Rent, Light and Heat			12,960.20	
Stationery and Printing			1,227.37	
Telephone and Telegraph			896.35	
Dues and Publications			526.97	
Express and Postage			2,540.96	
Welfare and Gratuities			3,000.00	
Traveling and Entertaining			9,762.50	
Repairs and Betterments			125.00	
Salaries - Executive			27,505.50	
Salaries - Others			26,950.22	

CHARLOTTE MILLS, INCORPORATED
GENERAL LEDGER TRIAL BALANCES (*Cont'd*)

Account	June 30, 1923 after closing		June 30, 1924 before closing	
	Dr.	Cr.	Dr.	Cr.
GENERAL ADMINISTRATIVE				
EXPENSE:				
Bond Coupon Tax			\$ 2,273.90	
Registrar Fees			600.00	
Transfer Fees			547.20	
Revenue Stamps			1,000.00	
Traffic Service			750.00	
Legal, Auditing and Profes- sional			12,650.90	
Directors' Fees			3,200.00	
Finance Fees			725.00	
Bad Debts			7,321.72	
Insurance Cost at Outside Bleachery			1,327.56	
Salaries - Executive			33,500.00	
Salaries - Treasurer's Dept			12,600.00	
Salaries - Legal and Taxes			6,000.00	
SELLING & DELIVERY EX-				
PENSE:				
Advertising Salaries			4,000.00	
Advertising Expense			65,926.30	
Commission to Cotton Prod- ucts Co.			124,578.16	
Commission to Textile Sell- ing Corp.			93,315.58	
Commission to Foreign Ex- port Corp.			4,035.51	
Cash Discounts to Customers			51,540.22	
Price Adjustments to Cus- tomers			6,590.11	
Sample Expense			14,962.91	
INTEREST AND DISCOUNT:				
Bond Interest			350,000.00	
Amortization of Bond Dis- count			226,770.88	
Discount on Bank Loans			20,000.00	
Discount on Banker's Notes				
MISCELLANEOUS:				
Strike Expense			116,590.32	
Shut-Down Expense			18,561.50	
Miscellaneous Taxes			8,650.22	
PRIVATE LEDGER CONTROL		\$ 839,235.94		\$ 1,060,760.24
	\$4,000,153.34	\$4,000,153.34	\$15,909,160.47	\$15,909,160.47

You are also presented with the following summary of physical inventories taken as of June 30, 1924:

Raw Cotton	\$1,389,667.19
Work in Process	921,699.13
Finished Cloth	1,762,801.76
Stores and Supplies	500,679.82
	<u>\$4,574,847.90</u>

The balance sheet of the company as of June 30, 1923, as certified by you, and as included in your previous audit working papers, is as follows:

CHARLOTTE MILLS, INCORPORATED
BALANCE SHEET, JUNE 30, 1923

ASSETS

CAPITAL ASSETS:

Mill Properties, Machinery, Equipment, etc., at cost	\$19,000,000.00	
Additions to Plant	2,810,823.20	
	<u>\$21,810,823.20</u>	
Less Reserve for Depreciation	2,144,279.81	
	<u>\$19,666,543.39</u>	
Goodwill, Trade-Marks, etc.	1.00	\$19,666,544.39

INVESTMENTS:

Securities of Associated Companies	\$300,000.00	
Other Investments	<u>126,542.30</u>	426,542.30

CURRENT ASSETS:

Inventories:		
Raw Cotton	\$1,100,537.90	
Work in Process	754,627.99	
Finished Cloth	1,490,997.31	
Stores and Supplies	<u>311,950.02</u>	\$ 3,658,113.22
Accounts Receivable, Trade, less Reserves	3,392,534.44	
Accounts Receivable, Employees	8,300.00	
Notes Receivable and Miscellaneous Securities, less Reserve	10,030.00	
Cash in Banks and on Hand	<u>452,226.50</u>	7,521,204.16

DEFERRED CHARGES:

Organization Expense	\$ 127,650.42	
Discount and Commission on Bonds	270,994.08	
Interest, Insurance Prepaid, etc.	<u>70,062.40</u>	468,706.90
		<u>\$28,082,997.75</u>

CHARLOTTE MILLS, INCORPORATED
BALANCE SHEET, JUNE 30, 1923 (*Cont'd*)

LIABILITIES

CAPITAL LIABILITIES:

Capital Stock:

Common Stock - 1,000,000 shares of no par value outstanding in hands of public . . .	\$12,654,725.30	
1st Preferred Stock - 10,000 shares of \$100 par value authorized and outstanding . . .	1,000,000.00	
2nd Preferred Stock - 15,000 shares of \$100 par value authorized and outstanding . . .	1,500,000.00	\$15,154,725.30

FUNDED DEBT:

First Mortgage 7% Gold Bonds, due June 30, 1936	5,000,000.00
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CURRENT LIABILITIES:

Notes Payable	\$ 5,500,000.00	
Accounts Payable, including accruals, payrolls, etc.	1,152,137.59	6,652,137.59

SUNDRY RESERVES:

Reserve for Federal Taxes	100,000.00
-------------------------------------	------------

<u>SURPLUS</u>	1,176,134.86
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\$28,082,997.75

Prepare a working balance sheet, or a working trial balance, for the current audit, showing in it the previous year's figures, the proper captions, and the current year's book figures before verification and adjustment.²

² Regular 7-column or 14-column working paper should be used in preparing all schedules called for in this audit. See Jackson, *Audit Working Papers*, pp. 48-49, and Appendix B, Exhibit 7.

Part III—Asset Verification: Cash, Securities, Notes and Accounts Receivable

PROBLEM 14

CHARLOTTE MILLS, INCORPORATED—PART II

Cash Count, and Examination of Notes and Securities

On July 1, 1924, at 9:00 A.M., you arrive at the main office of the company, and, after presenting your credentials to the treasurer, you count, in the presence of the cashier, the operating office petty cash fund. You find bills in the cash drawer as follows: 55 ones, 6 twenties, 9 fives, and 4 tens. There are 4 rolls of fifty-cent pieces, 3 rolls of quarters, 6 rolls of dimes, 3 rolls of nickels, and 10 rolls of pennies.¹ The loose coins are 23 pennies, 21 fifty-cent pieces, 19 quarters, 195 nickels, and 86 dimes. There are no vouchers, but there is a carbon copy of expense report No. 126 which totals \$246.39 and which was submitted to the treasurer for payment at the close of business June 30, 1924.² There are also two memoranda signed by the president of the company; one of these for \$200 is dated April 24, 1924, and the other for \$150 is dated June 16, 1924.³

The several mill office cash funds are likewise counted, by assistants sent from your office, on the morning of July 1; these assistants arrive at the various mills as the offices are opened. They report the condition of these funds as follows:

¹ Coins are wrapped in rolls as follows: fifty-cent pieces, 20 to a roll; quarters, 40 to a roll; dimes, 50 to a roll; nickels, 40 to a roll; pennies, 50 to a roll.

² These amounts (\$246.39 plus \$1,274.81) have been taken up in the company's records as of June 30, 1924. The original expense reports, together with the petty cash vouchers attached, will be available, in case you desire to examine them, when you take up later the regular work of the audit. Further details of these reimbursements will appear in Part IX of the problem.

³ See Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 17-21.

Location of Mill	Cash on Hand at 7:30 A.M. July 1, 1924	Copies of Expense Reports sent to the Treasurer (with vouchers) for reimbursement at the close of business, June 30, 1924 ²		Total of Fund
		#	\$	\$
Arlington	\$ 42.10	213 —	\$ 157.90	\$ 200.00
Boston	173.83	114 —	326.17	500.00
Cambridge	175.95	426 —	124.05	300.00
Charlestown	34.80	519 —	165.20	200.00
Dorchester	43.09	15 —	256.91	300.00
Melrose	65.44	97 —	134.56	200.00
Woburn	89.98	22 —	110.02	200.00
	<u>\$625.19</u>		<u>\$1,274.81</u>	<u>\$1,900.00</u>

Upon the completion of the cash count you obtain from the treasurer the following schedule of securities and notes:

TREASURER'S OFFICE SCHEDULE OF SECURITIES AND NOTES ON HAND JUNE 30, 1924			
Ledger Account	Description	No. of Shares or Par Value of Bonds	Book Value ¹
Investments in Associated Cos.	Cotton Products Company	1,500 sh.	\$150,000.00
	Textile Selling Corporation	1,000 sh.	100,000.00
	Textile Foreign Selling Corporation	500 sh.	50,000.00
Other Investments	Boston Cloth Mills, 6% Pfd.	1,000 sh.	100,000.00
	Amos Manufacturing Co.	636 sh.	54,726.75
Stock Subscriptions (Collateral) ✓	First Liberty Loan Bonds, 1932-47	\$300,000.00	
Mortgages	Mortgage note of John Smith		5,000.00
	Mortgage note of J. J. Loftus		11,000.00
Notes Receivable	Doe and Smith		4,000.00
	L. P. Jones & Co.		290.00
	Alfred Johnston, Supt.		4,500.00
	H. P. Bennett, Purchasing Agent		2,000.00
Miscellaneous Investments	Note of Waste Sales Corp.		15,000.00
	Note of J. A. Howard		1,500.00

At 10:30 A.M. the treasurer accompanies you to the vault of the Boston Vault Company where, in his presence, you examine the following securities and notes:⁴

² See footnote on page 83.

⁴ See Jackson, *Audit Working Papers*, pp. 65-67. See also Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 133-135.

Common stock certificates Nos. 14, 15, and 16 of the Cotton Products Company made out in the name of this company for 500, 500, and 490 shares respectively. Also certificates Nos. 17, 18, 19, 20 and 21 for 2 shares each. These certificates are in the name of individuals and are indorsed in blank. The treasurer informs you that these latter certificates are owned by the company and are the directors' qualifying shares in the Cotton Products Company. The par value of the stock is \$100 per share.

Common stock certificates Nos. 2 and 7 of the Textile Selling Corporation for 500 shares each. These certificates are made out in the name of this company. The par value of the stock is \$100 per share.

Common stock certificates Nos. 1 and 2 of the Textile Foreign Selling Corporation for 300 and 200 shares, respectively. These certificates are made out in the name of Charlotte Mills, Incorporated; the par value of the stock is \$100 per share.

Certificates Nos. 395 and 412, for 500 shares each of 6% cumulative preferred stock of the Boston Cloth Mills. These certificates are in the name of this company and have a par value of \$100 per share.

Certificates Nos. 957, 158, 159, 960, and 2019 for 100, 100, 100, 80, and 256 shares, respectively, of the common stock of the Amos Manufacturing Company. These certificates are in the name of Charlotte Mills, Incorporated. The stock is without par value.

First mortgage 7% gold bonds of Charlotte Mills, Incorporated, Nos. 56-95 inclusive, 117-136 inclusive, 483-492 inclusive, and 1111-1165 inclusive—all of \$1,000 denomination; interest coupons for June 30, 1924, were attached.

First Liberty Loan bonds, 3½'s, 1932-47, Nos. 1,109,654-63 inclusive, for \$10,000 each; Nos. 219,570-79, inclusive, for \$10,000 each; and Nos. 19,561-80, inclusive, for \$5,000 each. The treasurer informs you that these bonds are held as collateral for Accounts Receivable—Stock Subscriptions as follows: of the Cotton Products Company Nos. 1,109,654-63, of the Textile Selling Corporation Nos. 219,570-79, and of the Textile Foreign Selling Corporation Nos. 19,561-80, inclusive.

First mortgage of John Smith, for \$5,000, dated October 31, 1922, and due October 31, 1925, interest at 6% due and payable quarterly. Your examination of the mortgage shows it to be on land in Arlington. The mortgage has been properly recorded.

First mortgage of J. J. Loftus, for \$11,000, dated June 30, 1920 and due June 30, 1925; interest at 6% is due and payable June 30

and December 31 of each year. The mortgage which is properly recorded is on land and building located in Charlestown.

Promissory note of Messrs. Doe and Smith, for \$4,000, dated September 1, 1920 and due September 1, 1923. Interest is at the rate of 6% per annum.

Demand note of Messrs. L. P. Jones & Co., for \$1,000, with interest at 6%, dated October 15, 1921. Indorsements on the back of the note show payments on principal as follows: June 30, 1922, \$470; December 31, 1922, \$120; June 30, 1924, \$120. It is further noted on the paper that the interest has been paid in full to June 30, 1924.

Demand note of Alfred Johnston, superintendent, for \$10,500, with interest at 6% per annum, dated July 1, 1919. The interest is due and payable June 30 and December 31 of each year. Indorsements on the note show that the principal has been reduced annually \$1,200 and that interest has been paid in full to June 30, 1924; the current year's payment was credited as of June 30.

Demand note of H. P. Bennett, purchasing agent, for \$5,000, with interest at 6%, dated July 1, 1919. The interest is due and payable June 30 and December 31 of each year. Indorsements on the note show that the principal has been reduced annually by \$600 and that the interest has been paid in full to June 30, 1924; the current year's payment was credited as of June 30.

Six per cent note of the Waste Sales Corporation for \$15,000, dated March 15, 1924 and due September 15, 1924. Interest is payable at maturity.

Promissory note of J. A. Howard, for \$1,500, with interest at 6%, dated April 15, 1924 and due July 15, 1924. Interest is payable at maturity.

Later, during the course of the audit, you obtain additional information concerning the securities and notes which were examined on July 1, as follows:

The stocks of the Cotton Products Company, the Textile Selling Corporation, the Textile Foreign Selling Corporation, and of the Boston Cloth Mills were purchased at par. All of this information is contained in the working papers of your audit for the period ended June 30, 1923.

The June 30, 1924 certified balance sheet of the Cotton Products Company shows 5,000 shares of stock outstanding, having a book value of \$620,000. You have not examined the books or accounts of the Cotton Products Company.

The Textile Selling Corporation's balance sheet at June 30, 1924 shows a book value of \$672,000 for the 6,000 shares of stock outstanding. The book value of the Textile Foreign Selling Corporation is \$172,000 for the 4,000 shares of capital stock outstanding. The books and records of these companies have not been audited by you but the balance sheets presented to you have been certified by accountants in whose work you have confidence.

An analysis of "Other Investments" showed a purchase through brokers of 256 shares of no-par common stock of Amos Manufacturing Company at 110 on December 31, 1923; commission and expense on this purchase of \$24.45 was charged to this account. Your previous working papers showed that the 380 shares of no-par common stock of the Amos Manufacturing Company then on hand had been purchased at an average price of approximately \$69.85 per share. This stock was sold "over the counter" on June 30, 1924 at 112½.

The balance sheet of the Boston Cloth Mills, as certified by independent auditors as of April 30, 1924, showed a book value of par for the preferred shares and of \$995,000 for its 10,000 shares of common capital stock outstanding. The preferred shares are quoted at June 30, 1924, "asked 101, bid 95."

The interest on the two mortgage notes has been paid in full to June 30, 1924. As regards the Doe and Smith note your previous year's audit papers state that it was taken in a reorganization; the treasurer shows you correspondence stating that the note has been extended for one year. No interest has been paid on it.

The Waste Sales Corporation has filed a petition in bankruptcy. It has liabilities amounting to \$652,500 and total assets of \$80,000. A copy of the claim filed with the referee in bankruptcy is presented to you by the treasurer and is examined by you.

Your examination of the general ledger account, Reserve for Depreciation of Securities, reveals that no change has occurred in the account during the year. Your previous working papers state that the account was set up to record the difference between estimated realizable value and book value (cost) of other investments at June 30, 1923. One of the problems confronting you on the audit is to determine whether this reserve is inadequate, ample, or excessive.⁵

Examine critically all verification work which has been done with reference to the count of petty cash, and the examination of

⁵ See Hatfield, *Accounting*, pp. 87-98.

the securities and notes receivable. Is any additional work necessary, and, if so, what further verification should be made? Prepare working schedules which will show in usable form all information necessary or desirable in the conduct of the audit.

PROBLEM 15

TROJAN MEN'S SHOP

Count of Departmental Cash Funds

The Trojan Men's Shop, located in Garrant, New Jersey, operated eleven departments, as follows:

- | | |
|----------------|--------------------------------------|
| Department No. | 1 – Men's Furnishings |
| | 2 – Special Stationery (cards, etc.) |
| | 3 – Regular Stationery and Books |
| | 4 – Special Furniture |
| | 5 – Tailoring and Ready-to-Wear |
| | 6 – Second-Hand Books |
| | 7 – Tobacco and Candy |
| | 8 – Sporting Goods |
| | 9 – Hardware (special items) |
| | 10 – Mail Order |
| | 11 – Special Orders |

The store was near a large men's university, and a very large part of the total trade was with students; this explains why certain departments were maintained that usually would not be found in a men's shop.

The annual sales of the Trojan Men's Shop approximated \$1,000,000, and it was the custom of the management to have the accounts of the company audited annually by a firm of independent accountants. Messrs. T. H. Magill & Company, Certified Public Accountants, had been regularly retained as auditors; they took up the audit for the fiscal year ended December 31, 1928 on February 9, 1929. The departmental change funds and the petty cash funds were counted after store hours, on the evening of February 9.

Cash registers were located for convenience, or according to the class of merchandise, in the various departments; in some departments there were two or more registers. Nearly all of the

registers had several drawers for further subdivision of the sales; amounts were recorded by drawers, by clerks, and in total. The total amount in each register was cumulative from day to day; the other amounts were reset to zero each evening by the person taking the readings.

The contents of each drawer consisted of two parts: (a) cash

CASH COUNT SLIP				
.....DEPARTMENT				
CLOSING CASH.....(<i>Register No., Drawer No., and Date</i>)...				
Gold				
Checks				
Bills				
\$100				
50				
20				
10				
5				
2				
1				
Silver				
\$1.00				
.50				
.25				
.10				
.05				
.01				
Cash Memos.				
			Total	
COUNTED BY.....			CHECKED BY.....	
			CASHIER	

Figure 1

for change, and (b) cash from sales. When the store closed each day the department heads changed places, and emptied each drawer into two bags; the change money was placed in the first bag, and the receipts for the day, together with the count slip (Figure 1), in the other. The bags were then taken to the office and placed in the safe overnight; the following morning the cashier checked the count of the department heads, and prepared the change bags to have in them the proper proportions of pennies, nickels, dimes, etc. Because this latter operation took considerable time there was a second change bag, prepared the day before, for each drawer. Each bag was marked for the department, register, and drawer, and either "change" or "sales" as the case might be; change bags were also marked "1" and "2."

The senior assistant in charge of the audit obtained on the morning of February 9 from the store manager, Mr. E. F. James, a list of the cash registers and drawers; he also ascertained the amount of the cash change in each of the two bags assigned to each drawer.¹ This list was as follows:

<u>Dept. No.</u>	<u>Register</u>	<u>Drawer</u>	<u>Cash</u>
1	1	1	\$15.00
		2	15.00
		3	15.00
	2	1	15.00
		1	15.00
		2	15.00
	4	1	15.00
		2	15.00
		1	20.00
		2	20.00
2	1	1	20.00
3	1	1	20.00
		2	20.00
		3	20.00
4	1	1	50.00
5	1	1	15.00
		2	15.00
		3	15.00
	2	1	15.00
		2	15.00
		3	15.00
	3	1	15.00
		2	15.00

¹In the case of departments Nos. 6, 9, and 11 there were no cash registers, and accordingly there was only a single cash fund in these departments; similarly, there was only the one \$25 amount in the shipping room.

<u>Dept. No.</u>	<u>Register</u>	<u>Drawer</u>	<u>Cash</u>
6			\$100.00
7	1	1	20.00
		2	20.00
		3	20.00
8	1	1	15.00
		2	15.00
	2	1	15.00
		2	15.00
9			20.00
10	1	1	20.00
11			20.00
Petty Cash (Shipping Room)			25.00

Inasmuch as the store remained open until five o'clock, this being true on Saturdays also during the academic year, it was arranged to begin the count of the cash funds at six o'clock that evening; Mr. James, the manager, and his assistant agreed to be present throughout the count. The senior assistant in charge of the audit then proceeded to prepare skeleton schedules for the cash count; he not only prepared one for each drawer, but also, to provide for emergencies, made a few extra schedules with the department, register, and drawer left blank.² Similarly, schedules were prepared for the office petty cash, shipping room cash, and customers' remittances received that day to apply on account.

Aside from the auditors, the only persons to know of the planned cash count were the store manager and his assistant. It was necessary that they be informed of the proposed count in order that they might be present. At five minutes before six o'clock the senior and five junior assistants arrived at the store; as the store had closed at five o'clock, they were met at the door by the store manager, and proceeded at once to his office. A long table had been provided, about which the juniors were seated, two on each of the long sides and one at one end. At the opposite end of the table Mr. James, the store manager, took his position. Since the department heads had not yet brought to the office the money from the cash registers, the first bags counted were the change bags to be used the following morning; the store man-

² The form of these schedules is shown as Figure 3.

ager's assistant handed the cash bags to him, he made a record of them, and then turned them over to the senior assistant in charge of the audit.

As each change bag was marked for department, register, and drawer, and as the skeleton schedules which had been prepared were similarly marked, the senior took five bags, selected schedules matching them, and distributed them to the juniors, one apiece. While the juniors were noting the contents of the bags on the schedules, the senior arranged more bags and schedules to have new ones ready as rapidly as the juniors finished counting their first bags. As the count of a bag was completed the senior placed the bag on another table, which was under his control, and placed the schedule in another pile; when schedules were completely filled in they were set aside as finished. Thus each junior was kept busy counting, and the senior was assured that all schedules were being made out and all funds counted. During the entire count the store manager sat at the long table, and observed what was being done; his assistant brought change bags, or other funds or materials, to him as they were called for by the senior assistant in charge of the audit.

By six-thirty o'clock, when the count was just getting well under way, the various department heads began bringing in the money just removed from the cash registers; this was received in bags by the assistant to the store manager, and placed on the table where the manager made a record of the bags and then turned them over to the senior auditor for the count. To avoid mixing the change bags, the first day's bags when counted were placed in a separate pile from those brought up for February 9 by the department heads.

It was approximately nine o'clock by the time the cash change bags and the bags containing the receipts of the day from cash sales were counted and recorded; the Change Summary schedule and a few of the detail count schedules follow:³

³ It is not necessary, for the purposes of the problem, to reproduce the entire set of working schedules as prepared by the auditors; the reader should, however, study the forms until he understands the principles upon which the schedules are prepared, and he should determine whether or not the cash count was properly planned and executed.

TROJAN MEN'S SHOP
CASH COUNT
CHANGE SUMMARY, FEBRUARY 9, 1929

Department #	Register #	Drawer #	AMOUNT	
			Bag 1	Bag 2
1	1	1	\$ 15.00	\$ 15.00
		2	15.00	15.00
		3	15.00	15.00
	2	1	15.00	15.00
		3	15.00	15.00
	3	1	15.00	15.00
		2	15.00	15.00
	4	1	15.00	15.00
		2	15.00	15.00
	5	1	20.00	20.00
		2	20.00	20.00
2	1	1	20.00	20.00
3	1	Valentines	10.00	.....
		1	20.00	20.00
		2	20.00 (Figure 3)	20.00 (Figure 3)
4	1	1	50.00	50.00
5	1	1	15.00	15.00
		2	15.00	15.00
		3	15.00	15.00
	2	1	15.00	15.00
		2	15.00	15.01
		3	15.00	15.00
	3	1	15.00	15.00
		2	15.00	15.00
		1	100.00 (Figure 4)	.....
	6	1	1	20.00	20.00
7	1	2	20.00	20.00
		3	20.00	20.00
		1	15.00	15.00
		2	15.00	15.00
8	1	1	15.00	15.00
		2	15.00	15.00
	2	1	15.00	15.00
		2	15.00	15.00
9	1	1	.....	20.00
10			20.00	20.00
11			20.00	.....
			\$680.00	\$ 570.01 680.00
				\$1,250.01 (to Figure 8) (red) .01 (to Figure 6)
				\$1,250.00 (to Figure 10)

Figure 2

TROJAN MEN'S SHOP CASH COUNT Department No. 3 Register No. 1 Drawer No. 2 Counted February 9, 1929, 6 P.M., in presence of E. F. James, Store Mgr.						
DENOMINATIONS	CHANGE				CASH SALES FOR DAY	
	Bag 1		Bag 2		Count	Amount
	Count	Amount	Count	Amount		
<i>Bills</i>						
50's						
20's						
10's					9	\$ 90.00
5's			3	\$15.00	12	60.00
2's						
1's	10	\$10.00	2	2.00	1	1.00
<i>Silver</i>						
1's						
50's	3	1.50				
25's	25	6.25	2	.50	1	.25
10's	2	.20	5	.50		
<i>Nickels</i>	38	1.90	38	1.90	2	.10
<i>Pennies</i>	15	.15	10	.10	3	.03
		\$20.00		\$20.00		
		(to Figure 2)		(to Figure 2)		
<i>Gold</i>					(\$5.00) 1	5.00
						\$156.38
<i>Checks</i>					<i>Bank #</i>	
					35 59	9.50
					"	1.50
					"	5.50
					35 60	10.00
					"	6.00
					"	10.00
					35-629	15.50
					65 159	1.00
					20 10	3.00
					5-20	10.00
						\$228.38
						(to Figure 9)
					Cash slip in agreement	
					By WCW	

Figure 3

TROJAN MEN'S SHOP **CASH COUNT**

Department No. 6 Register No. Drawer No.

Counted February 11, 1929, 9:15 A.M.,

in presence of E. F. James, Store Mgr.

DENOMINATIONS	CHANGE				CASH SALES FOR DAY	
	Bag 1		Bag 2		Count	Amount
	Count	Amount	Count	Amount		
<i>Bills</i>						
50's						
20's						
10's	3	\$30.00				
5's	10	50.00				
2's						
1's	11	11.00				
<i>Silver</i>						
1's						
50's						
25's	1	.25				
10's	1	.10				
<i>Nickels</i>	3	.15				
<i>Pennies</i>						
		\$91.50				\$91.50
<i>Gold</i>						
<i>Checks</i>						
	*Memoranda	of cash purchases of second-hand books:			Bank #	
	One book	2/8/29	\$1.60			
	" "	2/9/29	1.60			
	Three books	2/9/29	5.30			
			\$8.50			8.50
	By EWF	No J. E. made for \$8.50 vouchers, it not having any relation to the amount of these on 12/31/28.				\$100.00
						(to Figure 2)

This fund was in a box which it was impossible to open when the other funds were counted; no key was available. I sealed the box and it was put in the safe with the other funds at 10:00 P. M. February 9, 1929.

The key was given me at 9:15 A. M. February 11, 1929 and I opened the box after breaking the seals myself. Before breaking them I inspected them and found them to be in the same condition as that in which I had left them. EWF.

*These memoranda were not in the box but were presented to me at 9:20 A. M. February 11, 1929. Receiving Department O.K. seen. Sellers' signature for receipt of cash O.K. Custodian of fund is Miss PHJ. EWF.

Figure 4

Voided sales rung up on the cash registers were represented in the cash sales bags by the tickets which the registers printed. On each ticket was marked the reason for its being voided; each was approved by the department head. These tickets were listed on a separate schedule, as shown in Figure 5.

TROJAN MEN'S SHOP CASH COUNT \$1,000 Fund — Voids					
FEBRUARY 9, 1929					
Department #	Register #	Drawer	Number of Sale	Amount (to Figure 9)	Remarks
10	1	1		none	
5	1	3	0001	\$ 0.00	Test
5	1	2	0114	.00	
5	1	2	0104	.00	Change
5	1	2	0045	1.50	
5	1	1	0259	.00	
8				none	
1	3	1	0001	none .00	(WCW) Open register
1	4	1	0499	.00	" "
1	4	1	0407	.00	" "
1	4	2	0497	.00	" "
7	1	1	0168	.30	Not clear Bag Dept. #7
7	1	2	0053	.30	" " " " " "
7	1	2	0152	.25	" " " " " "
5		5	0006	none .00	Open Register Bag Dept. #5
5	2	1	0201	" .00	" " " " " "
5	2	1	0252	" .00	" " " " " "
5	2	1	0283	" .00	" " " " " "
1	1	2	0097	" .00	" " " " " "
1	1	2	0260	" .00	" " " " " "
3	1	2	0132	.78	Wrong sale No No. on
3	1	2	0188	.30	Amt. " Ticket
3	1	2	0206	.30	" " " " " "
3	1	3	0050	1.40	" " " " " "
3	1	3	0007	none .00	" " " " " "
7	1	3	0006	.40	In Bag #7 Open Register
2		Valentines	0001	none	" " " " " "
8	1	1	0022	"	" " #8 " " " "
8	1	2	0047	"	" " " " " "
8	1	1	0023	"	" " " " " "
8	1	2	0261	"	" " " " " "
1	2	1	0064	.34	Wrong Amount
1	2	1	0034	1.28	
1	5	1	0153	.20	
1	5	2	0154	.15	
1	5	2	0129	5.00	Wrong Department
				\$12.50	
				By JFD	

Figure 5

All bags in the cash registers having been counted, the office petty cash funds and the customers' remittances not entered or deposited were next produced. It was found that these were inseparably intermingled; accordingly the funds were counted as produced, and the whole reconciled with the books of account. The summary schedule, and a few of the detailed schedules prepared in this count, were as follows:

TROJAN MEN'S SHOP	
CASH COUNT	
\$1,000 Fund* — Customers' Remittances, etc.	
SUMMARY, FEBRUARY 9, 1929	
Leather wallet	\$ 130.65 (Figure 7)
Customers' remittances not yet entered.	1,033.04
Cash and checks	1,009.75
Petty Cash box*	92.00
Customers' remittances	878.46
Cash and checks and vouchers.	649.96
" " " "	64.46
Odd checks	36.60
Shipping room fund	25.00
	3,919.92 (to Figure 8)
Less: Amount of this deposited 2/11/29 (Figure 8)	2,825.24
	1,094.68
Add: Amount of Deposit over (Figure 8)	5.31
	1,099.99
Short (Figure 2)	.01
	<u>\$1,100.00 (to Figure 10)</u>
*The count included also a \$100.00 petty cash fund. The total of \$1,100.00 for this schedule was, therefore, made up of:	
Main fund	\$1,000.00
Petty fund	100.00
	<u>\$1,100.00</u>
	EWf

Figure 6

TROJAN MEN'S SHOP CASH COUNT \$1,000 Fund — Customers' Remittances, etc. LEATHER WALLET Counted February 9, 1929, 6 P.M., in presence of E. F. James, Store Mgr.				
Denomination and Description	Count or Bank Number	Amount	Remarks	Checks Proven Good and Collected by March 5, 1929
Torn \$1 bills	4	\$ 4.00	Seen	
Petty Cash vouchers		18 22	Seen and counted	
<i>Bad Checks-Date</i>				
2- 5-29	35-59	6.00	Seen and listed	
2- 5	35-60	3.88	" " "	\$ 3.88
2- 4	35-60	3.50	" " "	3.50
2- 6	35-60	4.50	" " "	4.50
1-27	35-60	2.25	" " "	2.25
1-30	35-60	3.82	" " "	
1-21	Union Trust	6.02	" " "	6.02
1-22	11-10	10.00	" " "	10.00
12-29-28	35-434	5.00	" " "	5.00
6-11	35-60	3.00	" " "	
	35-60	13.00	" " "	
1-16-27	13-61	2.00	" " "	
1-13-29	70-121	2.00	" " "	
1-18	34-116	16.06	" " "	
1-21	35-60	5.00	" " "	
2- 4	33-59	5.00	" " "	5.00
1-30	38-2	3.00	" " "	3.00
1-20	33-59	10.00	" " "	10.00
1-30	33-60	4.40	" " "	4.40
Valentine change bag—I.O.U. signed by Mr. Hopkins		10.00	(Change in bag \$9.00)	
		\$140.65		\$57.55
Deduct: Valentine change—I.O.U. cash counted with change count		10.00	By BLM	
		\$130.65		
		(to Figure 6)		

NOTE: Cashier changed the amount in the change bag to \$10.00 on February 11, 1929 by placing in it \$1.00 from the cash sales for that department and changed the cash slip in the sales bag to agree. EWF

Figure 7

TROJAN MEN'S SHOP RECONCILIATION

Bank Deposit 2/11/29 with Receipts of 2/9/29

Count of Change funds 2/9/29 (Figure 2)	\$1,250.01	
Count of \$1,000 fund - remittances, etc. 2/9/29 (Figure 6)	3,919.92	
	\$5,169.93	
Less: Funds per General Ledger 12/31/28 and 2/9/29	2,350.00	
Remittances etc. to be deposited	\$2,819.93	
Add: Cash sales, 2/9/29, per count (Figure 9)	2,823.81	
	\$5,643.74	
Amount Deposited per Deposit Slip	5,649.05	
Deposit Over	\$ 5.31	(to Figure 6)
Remittances, etc., to be deposited, as above	\$2,819.93	
Deposit Over, as above	5.31	
Remittances, etc., deposited (Figure 6)	\$2,825.24	

Figure 8

TROJAN MEN'S SHOP CASH SALES

CASH REGISTER READINGS, FEBRUARY 9, 1929

Department Register and Drawer Numbers	Actual Cash Turned in	Day's Voids (Figure 5)	Together	Register Difference for Day	Over or Short
1-1-1	\$ 94.08		\$ 94.08	\$ 94.08	
2	67.53		67.53	67.53	
3	Discontinued				
2-1	42.47	1.62	44.09	44.09	
3-1	103.62		103.62	103.61	\$0.01
2	96.38		96.38	96.38	
4-1	175.64		175.64	175.64	.73
2	135.27		135.27	135.26	.01
5-1	84.99	.20	85.19	85.27	.08
2	30.00	5.15	35.15	35.15	
2-1-1	15.50		15.50	15.50	
Valentines	74.47		74.47	75.73	1.26
3-1-1	Discontinued				
2 (Figure 3)	228.38	1.38	229.76	229.73	.03
3	56.30	1.40	57.70	57.70	
4-1-1	78.09		78.09	77.42	.67
5-1-1	17.42		17.42	17.27	.15
2	10.00	1.50	11.50	11.50	
3	19.61		19.61	19.61	
2-1	97.50		97.50	97.38	.12
2	237.40		237.40	236.84	.56
3	56.68		56.68	56.68	
3-1	207.84		207.84	208.04	.20
2	117.52		117.52	117.35	.17
7-1-1	32.97	.30	33.27	33.27	
2	56.60	.55	57.15	57.15	
3	43.40	.40	43.80	43.80	
8-1-1	101.42		101.42	101.62	.20
2	170.59		170.59	170.39	.20
2-1	272.01		272.01	272.21	.20
2	41.79		41.79	41.79	
10-1-1	58.34		58.34	58.34	
	\$2,823.81	\$12.50	\$2,836.31	\$2,837.06	\$0.75
	√ (Figure 8)	√	√	√	√

Italics to be red.

Figure 9

The senior auditor and the store manager's assistant together then read and reset to zero the cash registers; the former made a record of the readings. As a result of this record and the count he prepared the schedule shown as Figure 9.

The schedule summarizing the whole cash count was as follows:

TROJAN MEN'S SHOP CASH COUNT GRAND SUMMARY, FEBRUARY 9, 1929		
Cash for change	(Figure 2)	\$1,250.00
Main and Petty Cash funds	(Figure 6)	1,100.00
Total change funds, per General Ledger, 12/31/28		<u>\$2,350.00</u>
		To B/S

Figure 10

When the store opened on Monday morning, February 11, the senior was on hand to inspect the contents of the tin box referred to on Figure 4, and also to count the shipping room fund.

He also observed the cashier check the change and the sales bags and make up the bank deposit. He accompanied the messenger to the bank, saw the deposit made, and secured a duplicate of the deposit slip.

Study the above schedules and text relating to the count of the cash funds of the Trojan Men's Shop; criticize constructively the entire procedure and state whether or not the count was properly conducted. Why was it necessary for the auditors to give consideration to the cash sales of February 9? Of what value for the purposes of the cash count are the data shown on Figure 5? Should anything else have been done by the auditors? Was any unnecessary verification made? Discuss.

PROBLEM 16

CRUSOE MANUFACTURING AND DISTRIBUTING CO.

Verification of Cash, and Bank Reconciliation

In the recurring annual audit of the Crusoe Manufacturing and Distributing Co. you are assigned by your senior to verify the cash and prepare a reconciliation of the cash book with the bank account. You have completed the count and reconciliation of petty cash funds, and accordingly proceed to verify the general cash balances. You ascertain that only one bank account is carried—the Grant Trust Company; you proceed to obtain the cash book, the check book, the bank statement and cancelled checks for December (the fiscal period ending as of December 31), and the company's bank reconciliation statement for November 30. Your past audits have been balance sheet, or limited-test audits; you have been instructed to make the usual verification of the cash funds. You next filled out a request-for-bank-confirmation form, had it signed by the treasurer, enclosed with it a self-addressed stamped envelope, and placed the letter yourself in the United States mail.¹

The company's November reconciliation statement, which had been handed to you by the treasurer, was as follows:

BANK RECONCILIATION, GRANT TRUST COMPANY

November 30, 1928

Balance, November 30, 1928, per bank statement \$186,215.93
Less Checks outstanding:

<u>Date</u>	<u>Number</u>	<u>Amount</u>	
9/ 6/1927	17,387	\$ 800.00	
12/14/1927	18,211	346.19	
3/ 5/1928	18,612	1,716.43	
10/18/1928	19,374	17.60	
11/ 6/1928	19,643	380.17	
11/24/1928	19,916	500.00	
11/28/1928	19,976	38.90	
11/30/1928	19,987	125.00	
do.	19,988	630.16	
do.	19,989	12.90	
do.	19,990	240.00	
do.	19,991	316.20	
			5,123.55
Balance, per Cash Book and Check Book			<u>\$181,092.38</u>

¹ For a typical form of request for bank confirmation see Jackson, *Audit Working Papers*, Appendix B, Exhibit 13.

The receipts side of the cash book gave the following information (special columns, explanations, etc., omitted) :

CASH RECEIPTS, DECEMBER 1928

Dec. 1 - Balance (brought forward)	\$181,092.38
Accounts receivable	14,612.72
Cash sales	3,703.19
2 - Notes receivable	1,600.00
Interest income - 60 d's, 6%	16.00
Accounts receivable	7,381.62
6 - Cash sales	463.29
Accounts receivable	1,746.29
8 - Accounts receivable	2,213.69
Notes receivable	1,117.22
Interest income - 60 d's, 6%	11.17
12 - Cash sales	346.19
Accounts receivable	78.65
Machinery and equipment - mch. #1721 sold	187.50
15 - Accounts receivable	462.87
Cash sales	126.15
20 - Accounts receivable	1,612.39
24 - Cash sales	1,378.67
Accounts receivable	786.19
28 - Notes receivable	3,786.83
Interest income - 60 d's, 6%	37.87
31 - Accounts receivable	4,672.86
Cash sales	2,177.63

All of the above receipts, according to the information given you, had been deposited daily in the bank and the deposits entered on the stubs of the check book. This you proceeded to verify by checking the receipts by days to the duplicate signed deposit slips, and seeing that all deposits had been entered on the checkbook stubs (see deposits as given on page 103).

You were further informed that all disbursements from the general bank account were made by check; the credit side of the cash book showed the following disbursements (special columns, explanations, etc., omitted) :

<u>Date</u>	<u>Check No.</u>	<u>Amount</u>	<u>Date</u>	<u>Check No.</u>	<u>Amount</u>
Dec. 1	19,992	\$ 200.00	Dec. 20	20,023	\$ 187.80
	3	14.80		4	66.78
	4	64.96		5	750.00
	5	287.33		6	1,092.17
3	6	1,364.96		7	64.19
	7	9.92		8	311.12
	8	16.43	24	9	1,600.82
	9	20.01		30	64.99
	20,000	116.45	28	1	62.33
6	1	83.27		2	16.95
	2	643.20		3	484.90
	3	812.33		4	362.12
	4	16.50		5	26.98
	5	100.19	30	6	400.00
8	6	1,311.90		7	500.00
	7	657.83		8	375.00
	8	12.48		9	400.00
	9	235.00		40	2,878.30
	10	63.10		1	64.83
	1	64.66		2	6,438.15
12	2	65.00		3	64.20
	3	119.29	31	4	38.40
	4	1,711.62		5	62.21
	5	4,007.80		6	392.30
	6	19.46		7	612.48
	7	44.86		8	147.22
15	8	17,386.42		9	88.60
	9	413.62		50	300.16
	20	112.91		1	93.84
	1	38.17		2	62.50
	2	63.44		3	112.18

The balance as shown by the cash book (the book had been ruled up and the balance carried down) was \$181,411.94.

The bank statement showed deposits made during December as follows:

<u>Date</u>	<u>Amount</u>	<u>Date</u>	<u>Amount</u>
Dec. 2	\$14,612.72	Dec. 13	\$ 424.84
	5,319.19	16	589.02
4	7,381.62	22	1,612.39
7	2,209.58	26	1,566.17
9	2,213.69	30	4,610.89
11	1,128.39		

Cancelled checks accompanying the December bank statement were as follows:

<u>Check No.</u>	<u>Check No.</u>	<u>Check No.</u>
18,211	20,004	20,026
19,374	5	7
19,643	6	8
19,976	7	9
87	8	30
8	9	1
9	10	2
90	1	4
1	2	5
2	3	6
3	4	7
4	5	8
5	6	9
6	7	40
7	8	1
8	9	2
9	21	3
,000	2	4
1	3	5
2	4	7
3	5	50

In addition, the bank statement showed a credit for December interest on the daily balances, the amount being \$307.29. It was the custom to take up this monthly interest in the books as of the month to which it was applicable, but because of pressure in the closing of the books it was overlooked at December 31. The bank statement showed a balance as of December 31 of \$179,379.62, and this was confirmed by the certificate received the following day from the bank.

Outline briefly what verification, other than that outlined above, you would make of the general cash funds of the company; be specific with reference to the principles and procedures involved.² Prepare the bank reconciliation statement which you would include among your working papers.

PROBLEM 17

CLARK DISTRIBUTING COMPANY

Verification of Cash Funds

The balance sheet of the Clark Distributing Company, as prepared by the bookkeeper of the company for the fiscal period ended

² See Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 17-33; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 94-105; Bell, *Auditing*, pp. 67-107.

June 30, 1928, showed among the current assets the item, "Cash, \$22,050.00." You have been employed to audit the company's accounts for the above fiscal period, and to submit a certified balance sheet to the stockholders; your analysis of the cash item reveals that it includes the following:

(a) Currency in cash drawer	\$ 175.00
(b) I. O. U.'s of employees	300.00
(c) Customers' checks dishonored and returned by the bank	1,705.00
(d) Stamps held in cash drawer	35.00
(e) Bond coupons due, but not presented for collection	400.00
(f) Cash at sales branches in distant cities held as working funds	2,500.00
(g) Cash in bank to cover checks already issued in payment of accounts payable, but which checks have not yet been presented to the bank for payment	7,385.00
(h) Cash in bank still subject to check — shown on stub of check book	9,550.00

Explain how you would proceed to verify the above items, and state at what amount you would be willing to certify the cash item in the balance sheet. Give reasons for your decision.¹

PROBLEM 18

CHARLOTTE MILLS, INCORPORATED—PART III

Verification of General Cash Funds

When you are ready to take up the verification of the general cash funds of the company, you find from your working sheets (the private and general ledgers' trial balances in your possession) that there are six separate cash accounts to be verified. One of these accounts appears in the private ledger, while five separate items appear in the general ledger trial balance, as follows:¹

<u>PRIVATE LEDGER</u>	
Cash	\$500.00
<u>GENERAL LEDGER</u>	
Cash — Banks	\$1,295,741.20
Cash — Operating Office	1,000.00
Cash — Mill Offices	1,900.00
Cashier's Advances	185.00
First Trust Co., Trustee	7,000.00

¹ See Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 17-33.

¹ The student should make sure that these amounts are in agreement with the trial balances furnished him in Part I of the problem.

Since the cash funds in the operating office and at the seven mill offices were counted and verified on July 1 you now give your attention to an analysis and verification of the other accounts.

On July 1 when you made your verification of the petty cash funds you ascertained that the company's funds this year were on deposit in five different institutions; you accordingly at that time sent out formal requests for confirmation, and now have in your possession these confirmations as follows:²

(a) First Trust Company:	
Checking account	\$123,486.72
Payroll account	13,833.33
Trustee account	7,210.00
(b) First National Bank:	
Checking account	\$624,397.54
(c) Second National Bank:	
Checking account	\$312,019.27
(d) Third National Bank:	
Checking account	\$ 89,904.88
(e) Pilgrim Trust Company:	
Checking account	\$272,707.22

You decide to verify first the private ledger account of \$500; this you find upon inquiry is a confidential payroll account from which officers' salaries and directors' fees are paid. Checks for such disbursements are drawn against this account and at the same time a transfer is made to this account from the general bank account for the total of such checks drawn.³ The treasurer informs you that it is contrary to the instructions of the board of directors for any one to see the details of this account; he offers, however, to give you a reconciliation of the account as of June 30, 1924, showing the numbers and amounts of outstanding checks, and to certify to its correctness. This you agree to

² For a form of bank confirmation commonly used by auditors see Jackson, *Audit Working Papers*, Appendix B, Exhibit 13. The auditor fills in the upper half of the form and has it signed by the treasurer or other proper official of the business under audit; the auditor also usually writes in the name of the bank at the top of the lower half of the form, and writes his initials, or some other symbol, as the reference. The banker fills in the lower half of the form and returns it directly to the auditor.

³ Because of the possibility of failing to differentiate between "check," the act of testing or verifying, and "check," the negotiable instrument, many auditors use the form "cheque" when referring to the negotiable instrument. The examination by the author of the reports of a considerable number of accounting firms reveals that the practice is more common than many suppose. Leading works on auditing also quite generally use this form of spelling; see, for example, Montgomery, *Auditing Theory and Practice*, 3rd ed., Vol. I, pp. 86, 502-510. In the fourth edition of Montgomery's work, however, the spelling "check" appears to be used exclusively.

accept as a verification of this account, especially because of the comparative insignificance of the amount.

The reconciliation was received a few days later in the form of the following letter:

CHARLOTTE MILLS, INCORPORATED

Treasurer's Office

John L. Harrison,
Treasurer

Boston, Massachusetts,
August 14, 1924.

Mr. J. M. Goode, Auditor,
First National Bank Building,
Boston, Massachusetts.

Dear Sir:

Confidential Payroll Account

In accordance with our conference of August 10, I am furnishing you with the following reconciliation of the confidential payroll account at the First Trust Company:

BANK RECONCILIATION - JUNE 30, 1924

Balance, per Bank Statement \$13,833.33

Less - Outstanding checks (all dated June 30,
1924):

#914 . . \$ 833.33	#918 . . \$3,000.00	
915 . . 2,000.00	919 . . 1,000.00	
916 . . 2,000.00	920 . . 2,000.00	
917 . . 500.00	921 . . 2,000.00	13,333.33

Balance, per books \$ 500.00

I certify that the above statement is true and correct.

(Signed) John L. Harrison
Treasurer

The Cashier's Advances of \$185 consists of an advance made to the purchasing agent for traveling expenses. The treasurer has in his possession a memorandum, signed by the purchasing agent, stating he had this balance at June 30, 1924; this memorandum you examined during the course of your audit.⁴

⁴ This is a common method, when the auditor is satisfied of the sufficiency of the company's system of internal check, of verifying small cash balances in the possession of

The First Trust Company, Trustee account of \$7,000 represents a payment made to the trustee on October 31, 1923, to secure the release of a plot of land in Arlington, which was sold to John Smith. The First Trust Company is trustee under the indenture of trust and mortgage securing the first mortgage bonds of the company. The land sold was a part of the property covered by the mortgage and Charlotte Mills, Incorporated had to substitute for the land an equivalent value before the Trust Company, as trustee, would permit the transfer of a clear title to John Smith. At June 30, 1924, the Trust Company credited Charlotte Mills, Incorporated, with interest at $4\frac{1}{2}\%$ per annum on the deposit. An examination of the cash book and supporting records revealed that the entire amount was repaid to the company on July 11; on this date the company had given a sworn certificate to the trust company stating that additions of at least this value had been made to the plant. These new additions, in other words, were in turn substituted for the special cash deposit. You examined a copy of the company's certificate to the trustee.

Verification of General Bank Accounts

You next proceed to verify the main cash balances; having obtained the general cash books, the check books, the company's bank reconciliation statements as of May 31, and the paid checks and bank statements for June 30 and July 31, you ascertain from the check books that the cash in banks at June 30, 1924, consisted of balances as follows:

First National Bank	\$ 597,623.11
Second National Bank	212,019.27
Third National Bank	89,904.88
First Trust Company	123,486.72
Pilgrim Trust Company	272,707.22
	<u>\$1,295,741.20</u>

traveling salesmen or other employees; the memorandum examined by you was in the following form:

Boston, Massachusetts,
July 10, 1924.

Mr. O. K. Buyer,
Purchasing Agent, Charlotte Mills, Inc.,
Boston, Massachusetts.

Dear Sir:

According to our records you had in your possession on June 30, 1924, a cash advance for traveling expenses of \$185. For purposes of the annual audit of our accounts will you please certify to the correctness of this amount, and return this letter to me.

Yours very truly,
(Signed) John L. Harrison
Treasurer

Correct:

(Signed) O. K. Buyer

The general cash book, on the debit side has a deposit column for each of the following banks:

First National Bank	- Checking account
Second National Bank	- Checking account
Third National Bank	- Checking account
First Trust Company	- Checking account
Pilgrim Trust Company	- Checking account

Deposits to special bank accounts are made through the general ledger columns. Similarly, on the credit side there are check, or disbursement columns for each of the above banks. At the end of the month the columns for each bank are balanced in order to get the balance of cash on deposit; the sum of these balances equals the balance in the general ledger account, Cash - Banks.

You ascertain that all payments are made from the account in the First National Bank, this being the only active account; the company's reconciliations of the other bank accounts show that, with the exception of the Second National Bank, there are no checks outstanding at June 30, 1924. You find that these reconciliations are in agreement, so far as the balances are concerned, with the bank certificates received by you; you accordingly begin the verification of the First National Bank account, intending later to check up each bank account in order.

The company's May 31, 1924 reconciliation statement for the First National Bank was as follows:

BANK RECONCILIATION - MAY 31, 1924⁵

Balance, May 31, 1924 per Bank Statement	\$458,485.40
Less Checks Outstanding:	
2/19/24 #25,044	\$ 525.00
4/ 3/24 27,918	1,917.46
5/ 8/24 28,003	2,000.00
5/18/24 28,416	145.07
5/31/24 28,887-28,935, inclusive	54,819.66
	59,407.19
Balance, May 31, 1924 per Cash Book	<u>\$399,078.21</u>

The receipts side of the cash book shows, for the First National Bank, the following entries for the month of June:

⁵ The company follows the practice, as set forth later in the problem, of stopping payment on all checks which have been outstanding for a year; the amount is debited to Cash and credited to Reserve for Outstanding Checks.

CASH RECEIPTS, JUNE, 1924

6/ 1	Balance, May 31, carried forward	\$ 399,078.21
	Accounts Receivable - Cotton Products Co.	29,816.02
	Miscellaneous Cash	1,400.00
6/ 4	Accounts Receivable - Cotton Products Co.	14,000.00
	Transfer from Second National Bank	25,000.00
6/ 5	Miscellaneous Cash	25.00
	Cash Sale	890.75
	Accounts Receivable - Cotton Products Co.	33,051.98
6/ 9	Transfer from Second National Bank	25,000.00
6/11	Transfer from Third National Bank	50,000.00
	Accounts Receivable - Textile Selling Corp.	16,903.09
	Miscellaneous Cash	1,850.25
6/12	Miscellaneous Cash	34.98
	Transfer from First Trust Co.	30,000.00
	Accounts Receivable - Cotton Products Co.	14,500.00
6/16	Accounts Receivable - Cotton Products Co.	29,680.51
	Transfer from Pilgrim Trust Co.	20,000.00
6/18	Transfer from Pilgrim Trust Co.	25,000.00
	Accounts Receivable - Cotton Products Co.	16,940.85
	Miscellaneous Cash	122.09
6/19	Miscellaneous Cash	1,109.22
	Accounts Receivable - Textile Selling Corp.	14,227.08
6/21	Transfer from Third National Bank	35,000.00
	Miscellaneous Cash	2,047.60
	Accounts Receivable - Cotton Products Co.	20,050.00
6/23	Accounts Receivable - Textile Foreign Export Corp.	19,445.17
	Miscellaneous Cash	119.00
6/25	Transfer from Third National Bank	40,000.00
	Accounts Receivable - Cotton Products Co.	26,450.27
6/27	Accounts Receivable - Cotton Products Co.	34,526.11
	Transfer from Third National Bank	35,000.00
	Miscellaneous Cash	8,940.22
6/28	Transfer from Pilgrim Trust Co.	20,000.00
	Accounts Receivable - Textile Selling Corp.	15,137.88
	Transfer from Second National Bank	100,000.00
6/30	Notes Receivable	1,800.00
	Accounts Receivable - Cotton Products Co.	46,087.20
	Miscellaneous Cash	4,019.03
	Total	<u>\$1,157,252.51</u>

All of the above receipts, according to information given you, have been deposited in the bank.

Your study of the system of accounting revealed that all disbursements are made by check; the checks are voucher checks and are entered individually in the cash disbursement book. The total of each day's disbursements is then entered as a credit in the general cash book. The general cash book (credit side) shows, in the First National Bank column, the following disbursements for June:

CASH DISBURSEMENTS, JUNE, 1924

<u>Date</u>	<u>Check Nos.</u>	<u>Amount</u>	<u>Date</u>	<u>Check Nos.</u>	<u>Amount</u>
6/2	28936-941	\$107,100.18	6/20	29277-283	\$ 7,014.26
6/3	942-945	9,807.10	6/21	284-295	20,901.33
6/4	946-982	9,078.79	6/21	296	1,014.20
6/5	983-29041	10,874.32	6/23	297-318	29,084.54
6/6	29042-76	26,900.01	6/23	319-341	11,426.11
6/7	77-83	21,413.76	6/25	342-367	21,007.05
6/7	84-100	30,926.09	6/26	368-384	9,826.19
6/9	101-111	12,047.20	6/27	385	1,000.00
6/9	112	516.00	6/27	386	2,714.26
6/11	113-130	4,039.26	6/27	387	1,692.71
6/12	131-146	9,807.02	6/27	388-398	10,207.05
6/13	147-158	21,914.21	6/28	399	2,500.00
6/14	159-176	33,607.79	6/28	400	2,500.00
6/16	177-196	27,706.04	6/28	401	5,412.01
6/16	197-216	6,003.97	6/28	402-420	9,404.90
6/18	217-250	10,098.16	6/30	421-466	35,760.05
6/19	251-276	23,605.00	6/30	467-478	22,719.84
					<u>\$559,629.40</u>

The balance on deposit in the First National Bank, as shown by the cash book (the book being ruled up and the balance carried down) is \$597,623.11.

The First National Bank statement for the month of June, 1924, showed a balance of \$624,397.54 at June 30, and deposits for the month as follows:

6/2 . . . \$31,216.02	6/12 . . . \$18,788.32	6/21 . . . \$ 55,050.00
6/4 . . . 14,025.00	44,500.00	6/23 . . . 21,611.77
25,000.00	6/16 . . . 49,680.51	6/25 . . . 66,450.27
6/5 . . . 33,942.73	6/18 . . . 25,000.00	6/28 . . . 69,526.11
6/9 . . . 25,000.00	16,940.85	6/30 . . . 20,000.00
6/11 . . . 50,000.00	6/19 . . . 15,458.39	100,000.00
		24,078.10
		409.13

The deposit on June 30 for \$409.13 was interest credited by the bank for June on the daily bank balances, but overlooked by the company in closing the cash book for the June period.⁶

Paid checks returned with the June bank statement were compared with the cash disbursement book as to payees and amounts; the dates of the checks and the indorsements were also noted. Finally the checks were examined to determine that they had passed through the bank during June; the checks returned included the following:

⁶ The Interest on Bank Balance account would probably be analyzed at this time to ascertain that all such interest had been taken up in the books. The student may assume that this has been done, and the account found correct.

Nos. 28003, 28416, 28887-28945, 28946-29111, 29113-29295, 29297-29384, 29388-29398, and 29402-29420.

All paid checks returned with the July bank statement were also examined to determine that none of them had been issued during the fiscal period under audit except those that were shown to be outstanding as per the bank reconciliation of June 30; June paid checks returned with the July bank statement were:⁷

Numbers	Amounts
29112	\$ 516.00
29296	1,014.20
29385	1,000.00
29387	1,692.71
29399	2,500.00
29400	2,500.00
29401	5,412.01
29421-466	35,760.05
29467-478	22,719.84

The July bank statement showed that a deposit amounting to \$51,906.23 had been made on July 1.

The bank statements and paid checks for July and August, 1923 (a year previous) had been examined during your audit of

⁷ With reference to the examination at a later date of checks outstanding as of the close of a fiscal period, it would appear that many auditors examine only those checks shown in their bank reconciliation as of the audit date; it is maintained, however, that all paid checks returned by the bank for the first month of the new year (or possibly longer) should be examined, and the outstanding checks appearing in the auditor's copy of the reconciliation for the close of the year should be checked against the checks then returned by the bank.

Supporting the view that only those checks shown by the bank reconciliation to be outstanding need be examined at the later date, the Federal Reserve Board bulletin, "Approved Methods for the Preparation of Balance Sheet Statements," p. 8, states as follows:

"Outstanding checks not examined in a previous audit on account of not having been returned by the bank, must be called for and traced into the cash book at the beginning of the current audit."

Statements appearing to have the same procedure in mind are found in other leading works on auditing; for example, see Montgomery, *Auditing Theory and Practice*, 3rd ed., Vol. I, top of p. 509, and also Bell, *Auditing*, middle of p. 73.

In the preparation of this problem the author sent copies of an earlier draft to principals in approximately a dozen leading public accounting firms; included in these were some of the leading accountants in the United States. Several of them were kind enough to comment at some length on various parts of the problem; from one of these letters the following is taken:

"There is too great a tendency on the part of auditors to examine at a later date only those checks outstanding at the end of the preceding year, although no check is made of the remainder of the returned checks in those months. Such procedure is, I think, essentially unsound. What purpose is to be served by it? It has been proved that there was, at the end of the preceding year, money in the bank to pay all the checks that the auditor's list showed to be outstanding; if any 'kiting' of checks existed over the end of the year it must have been by means of checks that were not in the auditor's list and not in the cash book. An examination of those checks known to have been outstanding would be of no use for the purpose of checking against manipulation of checks over the end of the year.

"To check against manipulation of checks over the end of the year the bank deposits for several days before the close of the old year and for a short time in the new year should be exactly agreed with the cash receipts as shown by the cash book; if the best possible check is wanted the returned checks for the first month of the new year should be compared both with the bank's list of checks paid and also with the list of outstanding checks and with the cash book entries."

See also Jackson, *Audit Working Papers*, near bottom of p. 101.

a year ago; it was found that all outstanding checks appearing in your reconciliation of June 30, 1923 had been paid by the bank during July and August, 1923. By this procedure you had been satisfied that there had been no checks outstanding at June 30, 1923 except those shown by the bank reconciliation.

All disbursements from the other bank accounts were found to be transfers of funds between banks. The bank statements and paid checks for each bank were examined for the month of June, 1924; the checks were checked to the cash disbursement book, and were then traced as deposits to the statement of the First National Bank. Each check was also examined to see that it was paid by the bank in June, that it was marked as a transfer of funds, and that the indorsement read "For deposit only." It was ascertained that in the case of the Second National Bank, there was outstanding at the close of business on June 30 check No. 4027, dated June 28, 1924, in the amount of \$100,000. This check was deposited in the First National Bank on June 30, and was paid by the Second National Bank on July 2. The check was examined, along with the other checks returned with the Second National Bank July statement.

Criticize constructively the verification of the general cash balances as set forth above. Should further tests have been made of the cash receipts and disbursements? If so, what? Prepare working schedules sufficient to support the cash item in the balance sheet; these schedules should later be fully cross-indexed to other related schedules.⁸

PROBLEM 19

EASTERN DEPARTMENT STORE

Treatment of Manager's Secret Cash Fund

During the first audit of the Eastern Department Store the senior in charge, while investigating the private payroll and

⁸ See Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 17-33; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 94-105; Bell, *Auditing*, pp. 85-107; Jackson, *Audit Working Papers*, pp. 100-105, and Appendix A, Schedules H-H5.

other papers kept by the manager and to which no one else had access, discovered that there was a special checking account in the manager's name in a bank with which the store did not customarily do business. The general cash fund had already been verified; this managers' fund was not recorded in the ledger, and accordingly had not been audited.

The amount of the fund as of the date of the audit was \$577.23. This was verified by a bank certificate and reconciliation of the bank account and check book. Bank statements and canceled checks from the inception of the fund, about three years previous, to the date of the audit were examined. With the exception of three checks which had been voided, all checks issued up to the date of the audit had been paid through the bank prior to that date. Vouchers supporting the disbursements were scrutinized and appeared to be proper and adequate.

The manager explained to the auditor that this fund was used to pay certain unusual expenses, such as detective service, which, for purposes of greater secrecy, he preferred to keep out of the regular accounts. The fund, he stated, was replenished irregularly as necessary and was not kept by the imprest system. The entry for such replenishments was:

General Expense	\$.....
To Cash	\$.....

Check No. 54, dated nine days after the close of the period under audit, was issued to pay expenses amounting to \$50 and applicable to the period under review.

Not including this secret cash fund, cash to be shown in the balance sheet amounted to \$5,309.97, other current assets to \$259,524.05, current liabilities to \$80,370.06, and total assets to \$814,381.74.

In view of the secrecy surrounding this fund and to meet the desires of the manager, the senior believed it was not necessary to have the balance sheet reflect it. Moreover, the schedules he had prepared regarding it were excluded from the current working papers, but were preserved with the permanent file.¹

May the secret cash fund be omitted from the balance sheet?

¹ See Jackson, *Audit Working Papers*, pp. 13-14, 16-17.

PROBLEM 20

HARD SURFACE PAVING COMPANY

Treatment of Checks Drawn to Order of Employees

The Hard Surface Paving Company of New York, N. Y., manufactures paving materials and also executes paving contracts throughout the United States. The organization has total assets of approximately \$30,000,000 and its accounts have been audited annually by Messrs. Jones and Smith, Certified Public Accountants, 120 Broadway, New York. The company's fiscal year ends as of October 31; each year the auditors have found a number of checks drawn to the order of various employees of the company; the total of such disbursements for the year ended October 31, 1928 was \$255,000. The employees, when questioned, stated that the money was turned over to various officers and superintendents of construction. The auditors found vouchers supporting these disbursements, the vouchers stating that the amounts were chargeable to selling expense. No further details of these expenditures, however, were shown on the vouchers.

The senior in charge of the audit made inquiry of the treasurer as to the use of these funds. The treasurer declined to give any specific information, stating that the auditor should be satisfied so long as the disbursements were covered by properly approved vouchers, and the checks were signed by authorized officers of the company. The auditor was satisfied before the completion of the audit, however, that this amount represented sums expended in connection with the obtaining of paving contracts.

In stating the accounts the treasurer of the company insisted that this amount be included in the general item of selling expense. After some consideration the auditor decided to state the item in the accounts in this manner but in his report to include a statement in his discussion of the income statement to the effect that, "included in the selling expenses of the year, is an amount aggregating \$255,000 represented by checks drawn payable to employees of the company."

Do you agree with the decision of the auditor? Discuss.

PROBLEM 21

MT. HOOD LUMBER COMPANY

Shortages in Cash

The Mt. Hood Lumber Company of Portland, Ore., was engaged primarily in the jobbing of lumber throughout the Northwest; the annual sales of the company approximated \$2,000,000 per year. The company had followed the practice for a number of years of having its accounts audited annually by independent accountants, and for several years this work had been done by Messrs. Bassett, Chamberlain & Co., Certified Public Accountants, Northwestern National Bank Building, Portland.

The company's fiscal year ended as of December 31, but inasmuch as the auditors each year had been requested to make practically a detailed audit of the cash transactions, and had followed the practice also of examining all vouchers, postings to the general ledger, footings of books of original entry, and so forth, it had been the practice to do a certain amount of interim work; the auditor would assign an assistant or two perhaps twice during the year to bring the work up to a certain point, so that at the end of the year only a small portion of the transactions of the period remained to be verified. The latter part of May and June being oftentimes a slack period, it was customary for the interim work to be brought up to, say, April 30; later in the year, probably in October or November, the transactions from April 30 to the end of September or October would be verified.

It was for this purpose that Messrs. Bassett, Chamberlain & Co. had assigned an assistant in October, 1928, to bring the audit of the accounts of the company up to September 30, or to October 31 if possible. During the course of the interim audit the assistant proceeded to check in detail the cash receipts, as recorded in the cash book, against the bank deposit slips; the bank deposit slips were prepared each day in duplicate, the duplicate being stamped and initialed by the teller receiving the deposit, and then returned to the depositor. These slips were retained by the business until after the accounts for that year had been audited, and oftentimes for longer periods of time.

By matching the bank deposit slips against the detailed cash

book items it became apparent that the company's cashier, Mr. Albert Harrison, was "lapping" cash receipts. The instructions of the company were that all cash receipts should be deposited intact each day in the bank, yet the auditor found again and again instances of where items recorded in the cash book under a certain date would appear on the duplicate deposit ticket several days later—oftentimes the amount on the deposit ticket would be a single amount aggregating a number of cash book items. When the auditor had found a sufficient number of such items to satisfy him that something was wrong, he brought the matter to the attention of the officials of the company; the general manager, Mr. George Cathcart, presented the questionable items to Mr. Harrison for his explanation. Mr. Harrison could offer none, and became very indignant at being questioned; he stated that he had been cashier of the company for more than ten years, and that his accounts would be found absolutely in order.¹ He tendered his resignation, effective at once, and left the office. This was on Monday, October 15; on Sunday, October 21, Mr. Cathcart received the following air mail letter by special delivery:

Los Angeles, California,
October 19, 1928.

Dear George:

I left the accounts short \$2,768.08 as per statement enclosed. I was in hopes I could get things straightened out, but I got behind. I just simply could not make ends meet on \$190 per month. I came down here to start all over again and see if I can get a foothold so I can get on my feet. I will pay every dollar as soon as I can get the money. I suggest that you make a claim on the Surety Company and then perhaps I can arrange to settle with it.

The amount \$2,768.08 is positively the total; if you prefer I will give you my note for the amount. You could then charge me and credit these accounts, which will straighten out everything. I would much prefer to have it that way.

I am awfully sorry to be in this predicament, but, as I say, I could not make the ends meet. I simply had to use the money to live on. I figure that you should have paid me at least \$60 per month more than you did.

¹ In the *First National Bank of Richmond v. Richmond Electric Co.*, 56 S. E. 152 (Va.), the court said: "In the commission of a forgery the employee is not the agent of his principal, and his knowledge cannot be imputed to the principal. But after the forged checks have been paid and returned to the depositor as vouchers . . . if the depositor assigns the duty of examining such vouchers and account to this same clerk, who has had the opportunity of committing a fraud and has done so, then such employee in the discharge of this duty is the agent of the depositor, and such depositor is chargeable with his agent's knowledge of the fraud."

I worked hard, and think I was entitled to some consideration. Will you give it to me?

Now George, I hope you will not be too hard with me. I was just beside myself to know what to do. Please write me here and let me know what action you will take, as it will greatly relieve my mind.

With kind regards, I am

Very truly yours,
(Signed) Bert

The statement referred to in the above letter was written on a sheet of paper as follows:

	Invoice	Discount	Net Cash
Jones & Smith Electric Co.	\$ 220.15	\$ 4.40	\$ 215.75
Foster Construction Company	827.76	16.56	811.20
Oregon Culvert Company	232.00	4.64	227.36
Smith, Kleiser & Company	678.21	13.56	664.65
Board of Education	178.34	3.52	174.82
Tacoma Mill & Lumber Co.	319.65	6.39	313.26
Regina Construction Co.	252.94	5.06	247.88
Highway Power & Light Co.	115.47	2.31	113.16
Totals	<u>\$2,824.52</u>	<u>\$56.44</u>	<u>\$2,768.08</u>

Prior to the receipt of this letter, Mr. Cathcart had instructed Messrs. Bassett, Chamberlain & Co. to do whatever work the firm considered necessary in order to determine if a shortage actually existed, and, if so, the amount. The auditors decided not only to make a detailed audit of the year's transactions up to October 15,² but also to circularize the accounts receivable as of September 30; the September 30 date was chosen for the customers' circularization because of the probability that many of the customers would not have their accounts in such shape that the October 15 balance would be available.³

² With reference to the requirements of a detailed audit see Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 522, 543-544, 547-553, 557-562, 577-587, 592-600, 632-633.

³ The form used for the circularization of the customers' accounts was as follows:

To.....

Dear Sir:

Our records, at the close of business on September 30, 1928, show a balance owed by you of \$.....

If the above balance is in agreement with your records, please sign, if not, please note exceptions, and return in the enclosed envelope to our auditors, Messrs. Bassett, Chamberlain & Co., Northwestern National Bank Bldg., Portland, Oregon.

This information is desired by our auditors only for the purpose of verifying the accounts in the course of audit on that date, and your prompt attention will be appreciated.

Yours very truly,
MT. HOOD LUMBER COMPANY

The above-mentioned balance is correct.

Remarks:

.....

About four hundred of these requests for confirmation were sent out by the auditors; as is always true in such cases a certain number of these—about sixty in number—were not returned. The remaining three hundred forty were received back by the auditors within a few days' time; as they were received they were carefully compared with the original list, and it was noted whether or not the balances shown by the company's books were accepted as correct. Of the confirmations returned, all except approximately twenty were in agreement with the company's own books; these were as follows:

<u>Name of Customer</u>	<u>Company's Books</u>	<u>Customer's Record</u>	<u>Difference</u>
Board of Education	\$795.47	\$102.20	\$693.27

The treasurer of the Board of Education stated that on October 10 a check for \$174.82 had been forwarded, and that all other bills except items amounting to \$137.42 had been paid. Of these \$35.22 was an October billing; the difference, \$102.20 was in agreement with the statement of September 30 received from the company. This meant an amount of \$693.27 unaccounted for.

Foster Construction Co.	827.76	422.08	405.68
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The note at the bottom of the confirmation stated, "Our records show \$422.08, due as at 9/30/1928, which is in accordance with statement from Mt. Hood dated 10/1/1928. This amount also has been paid now, so that at present we owe nothing." This was in accordance with the statement made by Mr. Harrison, the former cashier.

Smith, Kleiser & Co.	678.21	458.09	220.12
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The comment stated: "On Sept. 30 we owed for the September account only, namely, \$458.09. The August account was paid September 7, and the September account on October 9." This also gave information which was in agreement with Mr. Harrison's statement.

Jones & Smith Elec. Co.	220.15	Nothing	220.15
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The comment stated: "This account was paid in full on September 25." This agreed with the communication received from the cashier.

Oregon Culvert Company	463.29	231.29	232.00
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On the bottom of the confirmation was the statement that "our August account was paid on September 9." The \$232.00 was accounted for in Harrison's letter.

Judd Mill & Lumber Co.	1.96	Nothing	1.96
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This represented 2% discount on the customer's last purchase, and the customer's statement was accepted by Mr. Cathcart as being correct.

Tacoma Mill & Lumber Co.	439.80	120.15	319.65
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"The amount, \$120.15, is that shown by your statement of October 1," stated the comment on the bottom of the confirmation.

Clarke Lumber Company	7.83	Nothing	7.8
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The customer wrote across the bottom of the confirmation as follows: "We are unable to find any account with you for this amount. We have no invoice for it, and your account with us has been closed some time ago." Mr. Cathcart, the general manager, instructed the bookkeeper to accept the customer's statement as correct, and to prepare a journal voucher for his approval to write off the balance.

Portland Street Department	17.34	Nothing	17.34
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There was the following comment: "No record of above amount. Send Order No. and items, and when and where delivered." No record was found of such invoice having been sent, and no one was able to ascertain how the charge got into the accounts. Accordingly, Mr. Cathcart decided to write it off.

Regina Construction Co.	252.94	Nothing	252.94
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The comment was: "Our account was paid in full on September 24." This amount was again in agreement with Mr. Harrison's letter.

Highway Power & Light Co.	115.47	115.47	None
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The customer stated, however, that "we paid this account in full on October 7."

The remaining eight or nine accounts that were not in agreement were for small amounts, and, like the Judd Mill & Lumber Co. account and the Clarke Lumber Company account, appeared to be discounts taken by the customers but not entered in the books of account of the Mt. Hood Lumber Company. In some cases the customers had not paid their invoices within the discount period, while in other instances the credits to the customers' ledger had not been properly made; in all these instances, however, Mr. Cathcart decided to write off the small amounts.⁴

On the above basis, the auditor and Mr. Cathcart computed how much Mr. Harrison appeared to be short in his accounts; Mr. Cathcart wrote to Mr. Harrison again, asking about these discrepancies, but Mr. Harrison maintained that his total shortages were as given before. No other differences were found by the auditor, the interim work being brought up to October 31.

⁴ The general manager wrote to all customers who returned confirmation slips not in agreement with the Mt. Hood Lumber Company's books; these customers were asked to furnish detailed statements showing all transactions with the company during 1928.

Discuss the procedures followed in this case. How much was Mr. Harrison short in his accounts? What action would you take with reference to the matter? Why? Discuss fully.

PROBLEM 22

SPRAGUE INVESTMENT COMPANY

Verification of Securities Owned

The Sprague Investment Company was organized under the laws of the state of California in September, 1922, to hold the securities of J. B. Sprague; the company had an authorized capital stock of 100,000 shares of \$100 par value, and a sufficient number of shares were issued to pay for the securities turned over to the company. These securities, and their market values as of September 1, 1922, were as follows:

26,000 shares Sprague Manufacturing Company, out of a total of	
50,000 shares outstanding—par value \$100 per share	\$3,900,000.00
52,500 shares Sprague Public Service Corporation, out of a total of	
75,000 shares outstanding—par value \$50 per share	2,625,000.00
Total	<u>\$6,525,000.00</u>

On the basis of the above, 65,250 shares of the capital stock of the Sprague Investment Company had been issued to Mr. Sprague; four shares were in the names of others, in order to meet statutory requirements as to stockholders and directors, but these shares had been indorsed in blank and were in the possession of J. B. Sprague. The Sprague Manufacturing Company paid dividends at the rate of \$10 per share per annum, and the Sprague Public Service Corporation at the rate of \$2 per share per annum; as Mr. Sprague did not need this income for personal living expenses, at least not to any such extent, the bulk of the income was left undistributed in the hands of the corporation and was reinvested in the stocks and bonds of various corporations.

The fiscal year of the corporation coincided with the calendar year, and each year since the organization of the company its books and accounts had been audited by Messrs. Charles, Edwards & Co., Certified Public Accountants, Rusk Building, San

Francisco. While various captions appeared each year on the company's balance sheet, the major portion of the verification had to do with the securities and with the income resulting from them. Numerous purchases and sales were made each year, so that a very complete analysis and verification was made of all transactions having to do with the securities.

In the case of the audit for the year ended December 31, 1928, a large part of the detailed interim work had been completed before the close of the period. A day or two before the close of the year the assistant in charge of the audit prepared a list of all the securities shown by the books to be the property of the Sprague Investment Company, and on the morning of December 31 proceeded with another assistant and the treasurer of the company to the safe-deposit vault for the examination of the securities; the securities, and the values at which they were recorded in the books, were as follows:

<u>Description</u>	<u>Number of Shares</u>	<u>Amount</u>
American Corporation, Common "A"	7,500	\$ 198,500.00
Armour and Company, Common "B"	7,000	72,012.50
California Gas and Electric Co., Common	10,000	267,000.00
Caterpillar Tractor Company, Common	900	67,981.42
Caterpillar Tractor Company, Rights	900	2,571.08
International Oil Company, Common	4,000	38,395.71
Sprague Manufacturing Company, Common	26,000	3,900,000.00
Sprague Public Service Corporation, Common	52,500	2,625,000.00
Standard Oil Company of California	1,000	55,000.00
Standard Oil Company of New Jersey, Common	500	21,612.50
Totals	<u>110,300</u>	<u>\$7,248,073.21</u>

A detailed count sheet had been prepared before going to the safe-deposit vault; on this had been entered the name and description of the security, and the number of shares which the books of the company recorded as the company's property. Several lines had been left between each security on the count sheet; in this way the various certificates could be recorded as examined, the record showing both the certificate number and the number of shares accounted for. Comments could also be made with reference to indorsements on the certificates, and any other matters of interest.¹ The result of the count was as follows:

¹ For detailed instructions with reference to the examination of securities see Jackson, *Audit Working Papers*, pp. 65-66.

<u>Description</u>	<u>Number of Shares</u>	
	<u>Seen</u>	<u>Not Seen</u>
American Corporation, Common "A"	7,500	
Armour and Company, Common "B"		7,000
California Gas and Electric Co., Common	6,000	4,000
Caterpillar Tractor Company, Common		900
Caterpillar Tractor Company, Rights		900
International Oil Company, Common	1,500	2,500
Sprague Manufacturing Company, Common	2,000	24,000
Sprague Public Service Corporation, Common	22,500	30,000
Standard Oil Company of Calif.	1,000	
Standard Oil Company of New Jersey, Common		500
Totals	<u>40,500</u>	<u>69,800</u>

The records showed that the stocks of the Sprague Manufacturing Company and of the Sprague Public Service Corporation, aggregating 54,000 shares, were pledged to secure \$4,000,000 of collateral trust 6% gold bonds of the Sprague Public Service Corporation. The 4,000 shares of California Gas and Electric Company common stock were pledged with the First National Bank to secure bank loans, while the remaining stocks were in the possession of brokers to secure marginal accounts. In due course these were all confirmed in writing by the holders thereof, thus accounting for all securities shown by the company's books to be owned as of the close of business, December 31, 1928.

Upon the completion of the security count on the morning of December 31, the boxes were sealed and no one was to be given access to them until the bank was notified in writing by Messrs. Charles, Edwards & Co. that the boxes were to be released.² This release was given by the auditors on January 3, 1929.

The verification work was not taken up again until late in January, 1929, at which time brokers' advices for all purchases and sales of securities during the year were examined, the value of rights received was computed, profits and losses on sales were determined, dividends received were traced into the cash book, and it was ascertained from various sources that all dividends that should have been received were actually received. In the course of this verification work, the senior assistant in charge of the audit prepared the schedule shown on page 124.

² Various methods are used for keeping securities under control until the auditor has accounted for all items; sometimes a seal is placed over the edge of the box or vault, the seal bearing the initials of the in-charge assistant, while other times it is arranged in advance that the securities shall be under the control of the auditor (as in the present case) and that the bank will admit no one to the safe-deposit box except on the written instructions of the auditor.

SPRAGUE INVESTMENT COMPANY
STOCKS OWNED, DECEMBER 31, 1928

DESCRIPTION	BALANCE, DEC. 31, 1927		PURCHASES		REALIZED			BALANCE, DEC. 31, 1928			VERIFIED		DIVIDENDS RECEIVED 1928
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount	Profit or Loss	Number of Shares	Amount	Seen	Con- firmed		
American Corporation, Com- mon "A"			7,500	\$198,500.00					7,500	\$ 198,500.00	✓		
American Corporation, Com- mon "B"			7,500	78,890.00	7,500	\$ 82,610.00	\$ 3,720.00	7,000	72,012.50		✓	✓	
Armour and Company, Com- mon "B"			7,000	72,012.50				10,000	267,000.00		✓	4,000	20,000.00
California Gas and Electric Co., Common	10,000	267,000.00											\$ 1,400.00
California Investment Com- pany	700	\$ 43,757.50			700	50,928.50	7,171.00						405.00
Caterpillar Tractor Com- pany, Common			900	70,552.50		2,571.08*		900	67,981.42		✓	✓	
Caterpillar Tractor Com- pany, Rights			900	2,571.08*				900	2,571.08		✓	✓	
Daniels Properties, Inc., Common	100	14,430.00			100	15,166.00	736.00						100.00
Drug Incorporated, Common	100	9,222.50			100	11,008.50	1,786.00						125.00
Electric Western Corp'n, Common	500	52,337.50			500	52,075.00	262.50				✓	2,500	
International Oil Company, Common	4,000	38,395.71						4,000	38,395.71		✓		350.00
Powerful Motor Car Com- pany, Common			200	15,195.00	200	16,954.20	1,759.20						1,050.00
Riverside Mfg. Company, Common	600	38,572.50			600	45,603.00	7,030.50				✓	24,000	260,000.00
Sprague Manufacturing Com- pany, Common	26,000	3,900,000.00						26,000	3,900,000.00		✓	✓	105,000.00
Sprague Public Service Corp., Common	52,500	2,625,000.00						52,500	2,625,000.00		✓	30,000	3,000.00
Standard Oil Company of California	1,000	55,000.00						1,000	55,000.00		✓		375.00
Standard Oil Company of N. J., Common			500	21,612.50				500	21,612.50				
United States Steel Corp'n, Common			1,000	137,300.00									
	95,500 ✓	\$7,043,715.71 ✓	25,500 ✓	\$596,633.58 ✓	10,700 ✓	\$419,076.28 ✓	\$26,800.20 ✓	110,300 ✓	\$7,248,073.21 ✓				\$391,895.00 ✓

* Value of rights transferred. To stockholders of record December 20, 1928, to subscribe to one new share of stock at \$50.00 per share for each ten held. Rights expire February 1, 1929.

NOTE: Of the stocks owned at December 31, 1928, the following were pledged:—24,000 shares of Sprague Manufacturing Company common and 30,000 shares of Sprague Public Service Corporation common to secure \$4,000,000.00 collateral trust 6% gold bonds of latter company, and 4,000 shares of California Gas and Electric Company common to secure bank loans of \$150,000.00. Remaining 10,900 shares and 900 rights, as designated, pledged to secure marginal account with broker.

Each item on the foregoing summary schedule was supported by a subsidiary schedule showing: the name of the stock; the dates of all purchases and sales; the number of shares purchased and sold; the price per share and the total purchase or sale price; the name of the broker handling the transaction; the profit or loss on sales; the dividend rate per annum; the dates dividends were declared and paid, and to stockholders of what date;³ the amount of dividends received; and the source from which the dividend rate and dates of payment were verified. In case stock rights were declared during the year, the value of these was computed also.⁴ All schedules were cross-indexed to the security count sheet, except that in the case of the securities pledged the schedules were cross-indexed to the confirmations received from the holders of the stocks.

It was the custom of the Sprague Investment Company to carry all securities at cost in the balance sheet; however, the assistant satisfied himself that the stocks were worth approximately their book value—in nearly all cases the market value at December 31, 1928 was above the book value. In the case of the 10,000 shares of the California Gas and Electric Company common, for example, this stock had been held for a number of years; the book value was \$26.70 per share, whereas the market value at the close of the year under review was approximately \$60 per share.

A report was submitted by the auditor upon the completion of the audit; besides the balance sheet and income statement, the foregoing summary of stocks owned (with the column headed "Verified" omitted) was also attached as an exhibit. Both in the

³ The amounts of the dividend declarations, dates of declaration and payment, and so forth, were ascertained from the *Commercial and Financial Chronicle* so far as possible; if any of the securities held were not listed in the *Chronicle*, inquiry was made of an investment banking house, and in one or two instances a letter was written to the company whose stock was held and the information obtained direct. See Jackson, *Audit Working Papers*, pp. 66-71.

⁴ The computation of the value of "rights" is as follows:

$$\begin{array}{l} \text{Value of right : Cost of share of stock : : Selling price of right :} \\ \text{Selling price of right + Selling price of share of stock.} \end{array}$$

In the case of the Caterpillar Tractor Company stock, the 900 shares cost \$70,552.50, or \$78.3916 per share. The market value of one right was \$2.95, and of the share of stock "ex rights" was \$78.00. The computation would therefore be:

$$x : \$78.3916 :: \$2.95 : \$2.95 + \$78.00$$

The cost of one right, or "x" is, therefore,

$$\frac{78.3916 \times 2.95}{80.95} = 2.85676.$$

The value of 900 rights is, accordingly, 900×2.85676 , or \$2,571.08.

report, and in the balance sheet and exhibit of stocks owned, attention was called to the securities pledged; in the report it was specifically stated for what purpose they were pledged.

Comment upon the verification of the securities as outlined above. Was the verification sufficient? If not, wherein should it have been extended? Why? Was too much done in any respect? If so, what? Give reasons for your answer.

PROBLEM 23

THE BEDE MANUFACTURING COMPANY

Verification of Current and Investment Securities

The Bede Manufacturing Company, which owns all of the capital stocks (the directors' qualifying shares being indorsed in blank) of the Tharp Manufacturing Company and of the Carey Distributing Company, employs you to make the annual audit of its accounts as of September 30, 1927, and to certify the consolidated accounts of itself and subsidiary companies. No previous audit has been made of the company's accounts.

The stock of the Tharp Manufacturing Company consists of 5,000 shares of \$100 each, and is carried in the books of the parent company at \$860,000; the stock of the Carey Distributing Company consists of 4,000 shares of \$50 each, and is carried in the books of the parent company at \$320,000. These stocks have been owned throughout the year; no change has been made in the book figures since the date of their acquisition; the book figure for each security represents the net worth of the respective companies at the time the stocks were acquired. You are informed that these securities are in the company's safe-deposit box at the Golden National Bank.

The Bede Manufacturing Company owns also a one-third interest in the Riverside Manufacturing Company. The latter company is capitalized at \$600,000 (par \$100 per share); the Bede Company's investment stands in the books at \$180,000, this representing actual cost. There has been no change in this investment during the year.

You further ascertain that the Bede Manufacturing Company owns all of the stocks of the Calais Producing Company, capitalized at 2,000,000 francs. At the time the investment was made francs were quoted at \$0.0625. The current quotation at September 30, 1927 was \$0.0392. The stock of this company also was in the company's safe-deposit box at the Golden National Bank.

Included among the notes receivable of the Bede Manufacturing Company is a 600,000-franc note, representing funds advanced to the French subsidiary. This loan was made in 1921 at \$0.05875 per franc; at December 31, 1921 it was written up to the then current quotation of \$0.08135, at December 31, 1922, it was adjusted to current market, \$0.07335, and at December 31, 1923, to \$0.0510. No further adjustments had been made in the book value of this note. This note was produced to you with the other notes receivable of the company.

The records show also that the company owns \$100,000 (par) U. S. Steel Corporation 5's of 1950, which, together with the stock of the Riverside Manufacturing Company, are pledged with the Golden National Bank to secure funded indebtedness of the Tharp Manufacturing Company. The above bonds of the Steel Corporation are recorded in the books at par. You also ascertain from the records that the trustee has on hand in the sinking fund, to retire the indebtedness of the Tharp Manufacturing Company, \$12,614.29. Other securities owned by the Bede Manufacturing Company include the following:

<u>Description</u>	<u>Shares or Par</u>	<u>Cost</u>	<u>When Purchased</u>	<u>Interest or Due Dates</u>
U. S. Treasury 4¼'s - 1952 . .	\$200,000	\$200,000.00	At issue	April & October 15
U. S. Liberty 4¼'s - 1938 . .	300,000	298,746.50	5/1/1922	April & October 15
U. S. Treasury 3¾'s - 1947 . .	550,000	550,000.00	1927	June & December 15

These securities are in the possession of the Golden National Bank for safe keeping.

You are requested (a) to outline briefly the procedure necessary, for purposes of a balance sheet audit, to verify each of the

above items; (b) to state which items would appear in the consolidated balance sheet as of September 30, 1927 of the Bede Manufacturing Company and subsidiary companies, and at what values they would be included; and (c) to outline briefly the working schedules which should be prepared for the above verification.¹

PROBLEM 24

THE CALIFORNIA-PACIFIC COMPANY

Verification of Notes Receivable

The California-Pacific Company of San Francisco was the representative of several manufacturers of hardware, cutlery, firearms and ammunition, sporting goods, etc.; the company jobbed these goods from Alaska to Mexico, and as far east as Salt Lake City. The company had assets of approximately two million dollars, and its annual sales amounted to three and one-half million dollars. Its accounts were audited annually, as of December 31, by Messrs. Rembrandt, Wellington & Co., Certified Public Accountants, Standard Oil Building, San Francisco.

Almost immediately after taking up the audit of the company's accounts for the fiscal year ended December 31, 1927, the representative of the auditors examined its notes receivable. This was on January 16, 1928, the day on which the audit was begun.

From the general ledger, the auditor ascertained that notes receivable in the amount of \$48,507.96 were supposed to be in existence; upon inquiry he learned that the majority of the notes were received from customers who had not paid their accounts when due—in other words, the notes represented to a large degree past-due accounts receivable. In a few cases, however, customers gave notes at the time of the purchase of merchandise;

¹ See Jackson, *Audit Working Papers*, pp. 64-71; Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 53-57; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 132-140; Hatfield, *Accounting*, pp. 87-90; *Journal of Accountancy*, May, 1907, pp. 23-32.

this was true, for example, of the Esterley Hardware Company of San Francisco.

The auditor then obtained the pouch containing the notes, and was also given a typewritten list of the notes as prepared by the company's accounting department. All of the notes were then examined, including due dates, rate of interest, payments on account, notations of extensions allowed, and so forth. The auditor's schedule of the notes, together with his comments on them (in *italics*), is shown on pages 130-131.

The notes as examined were checked off on the list just to the right of the amount. Eight notes which appeared on the list were not seen; one had been paid prior to the examination of the notes by the auditor, six were out for collection, and one had apparently been misplaced by the former secretary-treasurer who had been discharged in August, 1927. The note which had been displaced was the \$90 note of the Black Hardware Company, but the debt was admitted by the company, according to Mr. J. C. Jurise, assistant treasurer and comptroller, and the company had agreed to pay the amount. At a convenient time the matter was also mentioned to Mr. Morrow, vice-president and general manager, who also assured the auditor that the debt was considered entirely good and collectible.

In the case of the \$600 note of the Esterley Hardware Company, due January 2, 1928, this was paid on January 5. At the time of the completion of the audit, February 2, the January cash book had not yet been written up, but the amount was traced to the January 5 duplicate deposit ticket, which had been stamped and initialed by a teller of the bank.

The notes of the Sammons Hardware Company, amounting to \$520.88, were admitted by the officials as of very doubtful value; they should be reserved for in full, and in the opinion of the general manager they were fully provided for in the existing Reserve for Bad Debts. Notes presumably are transferred to Accounts Receivable - Suspense whenever, in the opinion of the credit manager, they become uncollectible; because of certain recent changes in the organization these notes had been overlooked and the proper transfer had not been made.¹

¹ See Problem 25, pp. 133-141.

THE CALIFORNIA-
NOTES RECEIVABLE,

<u>Name of Maker</u>	<u>Address</u>	<u>Date</u>	<u>Due Date</u>
Arthur C. Jones Co.,	Lewiston, Idaho	7-17-1923	11- 1-1923
Black Hdwe. Company,	San Mateo, Cal.	4- 5-1926	7, 8, 9- 5-1926
Collins & Jackson,	Kendrick, Idaho	7-22-1927	12- 1-1927
Columbus Hdwe. Co.	Olympia, Wash.	12-13-1927	12-13-1928
Davis & Johnston,	Fresno, Calif.	7-30-1927	7-31-1927
Esterley Hdwe. Co.,	San Francisco	9-30-1927	1- 2-1928
" " "	"	"	2- 2-1928
" " "	"	"	3- 2-1928
" " "	"	"	4- 2-1928
" " "	"	"	5- 2-1928
" " "	"	"	6- 2-1928
" " "	"	"	7- 2-1928
" " "	"	"	8- 2-1928
" " "	"	"	9- 2-1928
" " "	"	"	10- 2-1928
" " "	"	"	11- 2-1928
" " "	"	"	12- 2-1928
" " "	"	"	1- 2-1929
Fairy Mer. Company,	Orlando, Calif.	2- 1-1924	6-18-1924
" " "	"	"	7-18-1924
E. H. Fuhriman,	San Francisco	12-21-1927	2-21-1928
Grace Hardware Co.,	San Francisco	2- 3-1927	11-25-1927
" " "	"	"	12-24-1927
Hanson Hdwe. Co.,	Los Angeles	11-23-1927	1-15-1928
" " "	"	"	2-15-1928
Hurdman & Jones,	Boise, Idaho	11-28-1927	1-30-1928
" " "	"	"	3-30-1928
" " "	"	"	5-30-1928
" " "	"	"	8-30-1928
Inglis Hdwe. Co.,	Medford, Ore.	8- 4-1927	11- 1-1927
Lincoln Hdwe. Co.,	San Francisco	12-31-1927	2- 6-1928
" " "	"	"	3- 5-1928
Lyons & Smith,	Red Bluff, Calif.	11-17-1927	11-18-1927
Monks Hdwe. Co.,	Long Beach, Calif.	1-26-1927	7-20-1927
" " "	"	"	8-20-1927
" " "	"	5-26-1927	11- 1-1927
Olson Hardware Co.,	Spokane, Wash.	8- 4-1927	10- 1-1927
" " "	"	"	10-15-1927
Pacific Hdwe. Co.,	Los Angeles	3-14-1927	8-17-1927
Prudy Hardware Co.,	Lewiston, Idaho	11- 8-1927	7- 1-1928
Reeve Hardware Co.,	Tacoma, Wash.	5-18-1926	On Demand
Sammons Hdwe. Co.,	Salt Lake City	4- 6-1925	1-10-1927
" " "	"	"	1-10-1927
" " "	"	"	7-10-1927
" " "	"	"	7-10-1927
" " "	"	"	1-10-1928
" " "	"	"	1-10-1928
Portland Hdwe. Co.,	Portland, Ore.	11-23-1927	12-31-1927
" " "	"	"	1-31-1928
" " "	"	"	2-28-1928
" " "	"	"	3-31-1928
Tunney & White,	Sacramento, Calif.	5-26-1927	9-21-1927

PACIFIC COMPANY

DECEMBER 31, 1927

Interest Rate %	Amount	Remarks
8	\$ 2,625.18✓	Good. Paid \$50 9/6/1927 nothing else in 1927.
8	90.00	Misplaced by former treasurer.
8	1,217.80✓	On back - "Cannot pay at this time." Good.
8	3,000.00✓	\$300 monthly after 2/1/1928
8	5,600.00✓	Payments to be made on account. Slow, but good. \$100 on 1/3/1928
8	600.00	Paid Jan. 5, 1928. Traced to bank.
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	600.00✓	
8	804.76✓	
8	200.00✓	\$200 paid 4/15/1926 on \$400 note. Check received Jan. 20, 1928, dated Feb. 9, 1928 for \$783.66
8	583.66✓	
8	4,000.00✓	
8	300.00✓	
8	1,145.62✓	Good, per Credit Manager.
8	300.00✓	Paid Jan. 17, 1928.
8	315.26✓	
8	400.00✓	
8	400.00✓	
8	400.00✓	
8	327.14✓	
8	1,458.64✓	Extension allowed. Promises to pay soon. Good.
8	400.00✓	
8	400.00✓	
8	2,500.00✓	Payable \$500 per month. Paid \$500 1/16/1928.
8	400.00✓	
8	400.00✓	
8	1,241.40✓	A tough one, says Credit Manager. Slow, but will be collected.
8	728.40✓	
8	728.40✓	Good.
8	533.22✓	Large current a/c also. Credit limit \$4,500.
8	702.00✓	
6	7,000.00✓	Balance due. Good, but slow.
-	156.20	Out for collection
-	17.46	" " "
-	156.20	" " "
-	17.46	" " "
-	156.16	" " "
-	17.40	" " "
8	300.00✓	Balance due. Paid \$300 in Dec. 1927
8	600.00✓	" "
8	600.00✓	" "
8	951.98✓	" "
8	133.62✓	Extension allowed.
\$48,507.96		
✓		

With reference to the note due November 1, 1923 of the Arthur C. Jones Co., Lewiston, Idaho, the company also had an active current account with a balance at December 31, 1927 of \$9,226.40. On November 14, 1927, \$2,000 was received in cash, and another \$1,000 on November 22. In January, 1928, cash in the amount of \$500 was received on the 18th, and \$2,000 on the 23rd. The California-Pacific Company could have applied these payments on the note, according to the general manager, but it preferred to apply them on the open account and let the note accumulate interest.

Inasmuch as the audit was completed on February 2, 1928, the auditor did not have an opportunity to determine whether or not the check of the Fairy Mercantile Company, Orlando, Calif., dated February 9, 1928, was paid or not. In the program of matters to be looked into when the audit for the year 1928 was taken up, the auditor made a notation for the assistant on the audit to see whether or not this check had been properly paid.

The auditor ascertained from inquiry and from the ledger that no interest had been accrued on any of these notes. The policy of the company was to attempt to collect interest when a note was paid, but if the maker refused to pay the interest the matter was generally dropped, especially if the party was a good customer. During the course of the verification the schedule of notes was footed, and was found to be in agreement with the balance of the account in the general ledger.

Upon the completion of the verification, the auditor prepared the following summary schedule:

<u>NOTES RECEIVABLE, DECEMBER 31, 1927</u>	
Notes not due at December 31, 1927	\$28,274.70
Notes past due:	
Less than three months	\$9,320.26
Less than one year, but more than three months . . .	7,414.16
More than one year	<u>3,498.84</u>
20,233.26	
Total, per detailed count, and per general ledger	<u>\$48,507.96</u>

This amount was carried to the current asset section of the balance sheet to be certified.

Discuss the verification made of the notes receivable of The California-Pacific Company. What other verification would the

auditor undoubtedly have made at the same time the notes receivable were examined? Give reasons. Should the auditor also have verified all changes that took place in the Notes Receivable account during the year under audit? If not, why not? If so, why? Discuss. Should any other verification have been made? If so, what? Discuss fully.

PROBLEM 25

THE CALIFORNIA-PACIFIC COMPANY

Audit of Accounts Receivable

In the audit of the California-Pacific Company for the fiscal year ended December 31, 1927, the auditors, Messrs. Rembrandt, Wellington & Co., found the following six accounts in the general ledger affecting the accounts receivable:

<u>Name of Account</u>	<u>Debit</u>	<u>Credit</u>
Accounts Receivable - Agents	\$491,994.98	
Accounts Receivable - General Dealers	132,233.18	
Accounts Receivable - Suspense	54,378.66	
Accounts Receivable - Miscellaneous	11,443.10	
Reserve for Bad Debts		\$ 5,718.90
Reserve for Losses on Suspense Accounts		27,694.46

The bulk of the accounts receivable were listed alphabetically under the names of the agents in whose territories the customers were located; the general dealers were certain large buyers, generally located in larger cities, and who might place orders through the traveling agent or directly with the company in San Francisco.

A daily report is received by all members of the Board of Trade of San Francisco, this report showing the names of all purchasers who may have been reported by any member as delinquent in payments, or as being in financial difficulties; if such daily report contains the names of any customers of The California-Pacific Company, those accounts are immediately transferred from the regular customers' ledgers to the suspense ledger. Through the Board of Trade an estimate is obtained of the loss that will be suffered on such accounts, and then specific provision is made for each account by debiting Reserve for Bad Debts and crediting Reserve for Loss on Suspense Accounts; frequently no

loss at all is suffered on accounts which are transferred to the suspense ledger.

The miscellaneous accounts receivable include amounts owed by salesmen on automobiles for which the company advanced the funds; claims against manufacturers for shortages and defective goods, wrong billings, and so forth; and claims against transportation companies for shortages, damage to goods in transit, billing at the wrong freight rate, etc. These claims are set up in the books only at the close of the fiscal period; during the remainder of the year they are handled on a cash basis only.

The Reserve for Bad Debts is credited monthly for a percentage of the sales of the month; the debit is to Loss on Bad Debts. The reserve is also credited for all amounts collected on suspense accounts previously charged off; it is debited for the amounts transferred to Reserve for Losses on Suspense Accounts. The latter account is then debited for accounts actually written off the books.

Upon taking up the actual verification of the accounts receivable, it was found that the Accounts Receivable – Agents, and the Accounts Receivable – General Dealers, were together in five loose-leaf ledgers of approximately one thousand accounts to the ledger. Each ledger contained a control sheet, and the ledgers were divided as follows:

Ledger No. 1 – Abernathy to Devoro	\$137,915.62
2 – Devos to Friedlich	103,556.90
3 – Friedmann to Loquvam	118,384.96
4 – Maddock to Stanley	122,899.22
5 – Starbuck to Miscellaneous	141,471.46
Total (sum of “Agents” and “General Dealers”)	<u>\$624,228.16</u>

As the first step in the verification of these accounts, adding-machine tapes were prepared for each ledger, and it was noted that the totals (taking into account credit balances on certain customers' accounts) were in agreement with the control sheets. A list of the credit balances—some eighty of them—was then prepared; the total of these credits was \$2,328.58, which amount was added to the above \$624,228.16 in order to obtain the total of the debit balances in the customers' ledgers. This credit amount was also added to the accounts payable, the journal entry (for working-paper purposes only) being as follows:

Accounts Receivable	\$2,328.58
To Accounts Payable	\$2,328.58

This journal entry, like others of similar import, was made on a separate schedule for "Adjusting Journal Entries."

The next step was to give special consideration to accounts past due; there were about three hundred of these accounts, and they were listed and analyzed as shown on page 136.

When the past-due accounts had all been listed and aged as shown on the preceding schedule, including a notation of the last payment made in 1927, the auditor obtained the cash book for January, 1928, to determine whether or not additional payments had been made since the close of the fiscal year.¹ Then, when it was mutually convenient, the accounts were discussed with the credit manager, and many of the larger amounts were further discussed with Mr. Morrow, vice-president and general manager; both of them were definitely of the opinion that the reserves which had been provided were ample to take care of losses which might occur from existing receivables. In fact, Mr. Morrow was of the opinion that if they continued monthly to set aside as large a percentage on sales as a provision for uncollectible accounts, they would have at least \$10,000 at December 31, 1928 to write back to Profit and Loss.

From his previous working papers, the auditor knew that at December 31, 1926 the past-due accounts amounted to approximately \$450,000 as compared with \$262,000 at December 31, 1927. The sum of the reserves for bad debts and suspense accounts was approximately \$33,400 at December 31, 1927 as compared with \$21,600 at December 31, 1926; this meant a total reserve for suspense accounts and bad debts of about \$10,800 more at the close of 1927 than at the close of 1926. The condition of these reserves, coupled with the fact that the accounts receivable were approximately \$164,000 less at December 31, 1927 than at December 31, 1926 (\$690,000 as compared with \$854,000), and that collections were coming in very well, satisfied the auditor that the reserves were probably ample. It was also observed from the records that only \$13,600 net of accounts were written off during 1927 as compared with a total reserve at the

¹ The best proof that an auditor can have that an account was good at the close of a fiscal period is for it be paid in cash subsequently.

THE CALIFORNIA-PACIFIC COMPANY
PAST-DUE ACCOUNTS RECEIVABLE, DEC. 31, 1927

Salesman	Name of Customer	Address	Total		Not Over		90 Days to 1 Year		Over 1 Year	Last Payment		Condition of Customer	Remarks
			Balance	Due	Past Due	Due	Past Due	Due		Date	Amount		
BARR	J. R. Edwards	Corvallis, Ore.	\$ 63.88	\$ 63.88						10-17-1927	\$ 177.29	Good	Account good—Treasurer.
	T. M. Larkin	Newburg, "	2,117.68	1,207.64	\$ 97.96					9-16-1927	374.68	O.K.	Crop conditions improving.
	Etc.												
BUXTON	E. L. Georges	Auburn, Calif.	8,066.96	2,545.64	2,318.92					1-18-1928	200.00	O.K.	Collections from customers slow
	Geo. Jenkins & Son	Orlando, "	2,112.12	554.00	834.14	\$	362.94	10-29-1927			360.60		An older balance of \$915.26 in notes.
	Brown Mdse. Co.	Roseville, "	74.10	74.10						None made			From September
FERGUSON	Delta-Smith Co.	Antioch, Calif.	1,862.12	298.80						12-31-1927	2,000.00	O. K.	
	Pine Hdwe. Co.	Richmond, "	4,001.20	1,640.62	1,243.03					12-12-1927	500.00		From April, 1927.
	Etc.												
NELSON	Bell Hdwe. Co.	Glendale, Calif.	1,433.58	57.62	801.78					51.08	3-7-1927	723.50	From March, 1926.
	Moro Hdwe. Co.	Long Beach, "	489.12	215.84						68.96	8-15-1927	210.33	Transferred 1-27-1928 to Suspense.
	Etc.												
Etc.			Etc.	Etc.	Etc.								

Totals, ... \$421,262.40 \$141,066.70 \$110,509.80 \$10,179.32
\$261,755.82

beginning of the period of \$21,600. The auditor was also impressed with the general improvement, during the year that Mr. Morrow had been general manager, in the organization and in the spirit of cooperation that was evident.

In considering the sufficiency of the reserves for bad debts and for suspense accounts, the auditor had also taken into account the Accounts Receivable – Suspense of \$54,378.66 as well as the past-due accounts amounting to \$261,755.82. The Reserve for Losses on Suspense Accounts was more than 50% of the total accounts in suspense; some of these accounts had reserves against them of only 10%, while others were reserved for 90% or more. The credit manager was of the opinion that the company would collect more than the net book value of these accounts. The suspense accounts had been listed from the accounts receivable suspense ledger as follows:

<u>Name of Customer</u>	<u>Address</u>	<u>Balance Owed</u>	<u>Reserve²</u>
Backus Hardware Co.	Salinas, Calif.	\$ 745.98	\$ 74.60
Ayer and Morris	Portland, Ore.	182.90	104.98
Davis Hardware Co.	Medford, Ore.	4,896.24	3,121.42
Lake Hdwe. Company	Arbuckle, Calif.	1,648.82	687.76
Emerson Hdwe. Co.	San Francisco	5,635.36	2,535.92
Etc.	Etc.	Etc.	Etc.
Totals		<u>\$54,378.66</u>	<u>\$27,694.46</u>

The auditor examined the cash book to ascertain when the last payment had been received on these various accounts, and noted on the schedule any payments that had been made since December 31, 1927. In two or three cases it was observed that the last cash received was in the nature of a liquidation dividend; in such instances the reserve provided was seen to be approximately equal to the balance still owed by the customer.

In the case of the miscellaneous accounts receivable, the total of \$11,443.10 comprised three groups of items, viz.:

Owed by salesmen on automobiles	\$ 5,227.04
Factory claims	2,401.68
Transportation claims	3,814.38
Total	<u>\$11,443.10</u>

² The amount of the reserve against each of these suspense accounts was determined largely from the report received from the San Francisco Board of Trade; this report is made after all creditors have stated their claims and the debtor has given a statement of his assets, and such other information as may be obtained. Usually by this means the debtor is not forced into bankruptcy, and the creditors obtain a larger percentage of what is owed them than if the matter was carried into the courts.

Fourteen salesmen owed balances on the purchase of automobiles for which the company had advanced the funds. These amounts were all listed by salesman's name and amount, and memoranda were obtained from all salesmen acknowledging the correctness of the balances owed.

The factory claims were listed by date, claim number, and amount. All outstanding claims were inspected by the auditor, the presence of proper supporting documents noted, and the prices of the articles making up the claims verified by inspection of the original invoices received from the factories. It was definitely ascertained that the total of such claims was in agreement with the general books of account.

All transportation claims were handled by Messrs. Carter & Bishler, from whom payment is received when the claims are adjusted. When Carter & Bishler write up the claim to be filed with the transportation company, a copy of the billing is sent to The California-Pacific Company; this constitutes the company's record of the case, and from it the account receivable is set up. These claims were verified by inspection of the duplicate claim sheets, and their total was further verified by a certificate from Messrs. Carter & Bishler.

On August 16, 1927, Mr. J. R. Fawcett, the secretary-treasurer, had been discharged; shortly thereafter he had been discovered to have been short in his accounts as of that date. He made a signed confession of a part of his shortage; Messrs. Rembrandt, Wellington & Co. had been employed to ascertain the amount of his intromissions, and had submitted a report showing the amount as \$10,550.32. As a part of the audit, the auditor was interested to ascertain what the final disposition of this had been, so far as the accounts were concerned; he found that the entire amount had been received from the Surety Company and had been entered in the cash book under date of November 23, 1927. This amount, in connection with the verification of the cash, had been traced into the cash book and bank; the following entry had been made in the books of account:³

³ The special examination in August had revealed that the intromissions had occurred in three main ways, viz.: certain factory and transportation claims collected, in the amount of \$800, had not been credited to those accounts, but had been appropriated instead; certain company checks had been drawn payable to Cash, the checks cashed at the bank by the treasurer, and the amounts charged to various salesmen as "traveling expenses advanced"—inasmuch as the salesmen never saw the books, the treasurer felt they would never discover the fact; and various customers' remittances, which the treasurer indorsed as an official of

Cash	\$10,550.32
To Accounts Receivable - Miscel- laneous	\$ 800.00
Traveling Expenses Advanced	2,230.00
Reserve for Losses on Suspense	7,520.32

The Reserve for Bad Debts, and the Reserve for Losses on Suspense Accounts, which have already been stated to have satisfied the auditor as being ample, were scheduled in detail as follows:

RESERVE FOR BAD DEBTS

Balance, December 31, 1926, per R. W. & Co.'s working papers	\$ 1,449.14
Amount reserved during 1927:	
0.75% of Net Sales for January and February	\$ 3,201.94
1% for remaining ten months	<u>22,082.52</u>
	25,284.46
Amounts collected on Suspense Accounts previously charged off	<u>11,161.56</u>
	\$37,895.16
Less: Amounts transferred to Suspense for estimated losses	<u>32,176.26</u>
Balance, December 31, 1927, per Ledger	<u>\$ 5,718.90</u>

As verification of the above, journal vouchers were seen for the monthly provisions based upon net sales, and all amounts collected were traced to the cash book; of the \$11,161.56 collected on accounts previously charged off, \$7,520.32 was received from the Surety Company to cover the intromissions of the former treasurer.

The amounts transferred to the Reserve for Losses on Suspense Accounts were also covered by journal vouchers, which were inspected; the latter reserve was scheduled as follows:

RESERVE FOR LOSSES ON SUSPENSE ACCOUNTS

Balance, December 31, 1926, per R. W. & Co.'s working papers	\$20,181.76
Add: Amounts transferred from Reserve for Bad Debts to cover esti- mated losses on Suspense accounts	<u>32,176.26</u>
	\$52,358.02
Less: Accounts charged off as uncollectible	<u>24,663.56</u>
Balance, December 31, 1927, per Ledger	<u>\$27,694.46</u>

the company, were appropriated to himself—the accounts were later transferred to Suspense at his order, and still later written off. This was an interesting case of what may happen when a single official acts in too many capacities within a business.

The list of accounts to be written off was prepared by the credit manager, and then was gone over with Mr. Morrow, vice-president and general manager, according to the latter's statement to the auditor. The journal voucher to write off the accounts was then prepared by the assistant treasurer, who, since the discharge of the former treasurer, had been in charge of the accounts. The general manager stated that beginning with 1928 uncollectible accounts would be written off quarterly, and all items would be approved by him. An even fifty accounts were written off for 1927—except for one account of \$4,066.10, all amounts were less than a thousand dollars. The list of accounts, together with the journal voucher, was inspected by the auditor.

During the course of the audit, the auditor also gave special consideration to the methods by which customers' orders were filled, and he was satisfied that the system of accounting was such that all merchandise actually shipped was invoiced to customers, and that the invoices were properly entered in the books of account. The shipping records and the sales books had been examined, during the verification of the inventories, for December 29, 30, and 31, 1927, and for January 2, 3, and 4, 1928, and the auditor was satisfied that all merchandise billed to customers before the close of the fiscal period had either been shipped, or that it had been set aside physically for the filling of the orders and had been excluded from the inventory.⁴ Careful inquiry was also made regarding the company's policy with reference to shipping out goods on consignment, or on memorandum billing; this was discussed with several different individuals throughout the organization, and the auditor was informed that no merchandise was on consignment or memorandum billing—this point the auditor specifically covered in the inventory certificate obtained upon the completion of the audit. The auditor also watched for memorandum billings, and for comments of any kind in customers' accounts which would lead him to believe that merchandise was held on consignment, but he found none.

⁴ According to the Uniform Sales Act, adopted by many of the states, it would appear that "definite and bona fide orders which are properly accepted by a business, provided the goods ordered have a definite existence and are owned by the organization and are set aside physically for the filling of these orders and thereby taken out of the inventory, may properly be included in accounts receivable, although such goods are still on the floors of the seller awaiting later shipment to the buyer." See on this point, Conchman, "Requirements of a Balance-Sheet Audit," *The Journal of Accountancy*, Vol. XLVII (January, 1929), pp. 20-36 (especially pp. 27-31).

Upon the completion of his verification and of the various schedules above referred to (aggregating some twenty sheets of working paper all-told), the auditor prepared the following summary schedule:

ACCOUNTS RECEIVABLE SUMMARY, DECEMBER 31, 1927

Accounts Receivable - Agents	\$491,994.98
Accounts Receivable - General Dealers	132,233.18
Total, per General Ledger	<u>\$624,228.16</u>
Add: Credit balances transferred to Accounts Payable	2,328.58
Total Agents' and Dealers' Accounts	<u>\$626,556.74</u>
Accounts Receivable - Suspense	54,378.66
Accounts Receivable - Miscellaneous	11,443.10
Total Accounts Receivable, December 31, 1927	<u>\$692,378.50</u>
Deduct: Reserves -	
For Bad Debts	\$ 5,718.90
For Losses on Suspense Accounts	<u>27,694.46</u>
Accounts Receivable net, per Balance Sheet	<u><u>\$658,965.14</u></u>

In the balance sheet itself, which was prepared for certification, the auditor showed the total accounts receivable of \$692,378.50, the total reserves of \$33,413.36, and the net amount (extended among the current assets) of \$658,965.14. He believed that the amount owed by salesmen on automobiles was too small to set up as a separate item in the balance sheet, and accordingly it was combined with the amounts owed by trade debtors.

Criticize constructively the verification of accounts receivable set forth above; was the verification sufficient for the purposes of a limited-test audit? Discuss. Should anything have been done which was not done? Was too much done in any respect? Give reasons for your answers.

PROBLEM 26

CHARLOTTE MILLS, INCORPORATED—PART IV

Verification of Accounts Receivable

It is common practice in the textile industry for a company producing cloth goods of any kind to sell its products through one or more selling companies. In the case of Charlotte Mills, Incorporated, its products are sold through the Cotton Products Co., the Textile Selling Corporation, and the Textile Foreign

Selling Corporation, all of New York. When you inspected the securities on July 1 you found shares of each of these selling companies;¹ Charlotte Mills, Incorporated, however, does not own a majority interest in any of them, though the companies are very closely associated.

Practically all sales of cloth are made through the selling companies and the amounts given in the trial balance are the June 30 balances owing to Charlotte Mills, Incorporated. These balances are as follows:

Cotton Products Company	\$1,452,699.77
Textile Selling Corporation	542,100.20
Textile Foreign Selling Corporation	3,457.90

These balances represent amounts owed by customers of the selling companies for cloth sold at market prices, and for cash collected by the selling companies and not yet remitted to Charlotte Mills, Incorporated. Commissions to the selling companies for cloth sold are computed as of the date the sales are made, and are charged on the Charlotte Mills books to Selling Expenses—Commission, and are credited to Accounts Payable.

The balances receivable from the selling companies represent to a large extent current sales. The accounting procedure for sales on the Charlotte Mills books is to charge the selling companies at the end of the week for the total of the weekly sales to customers; the selling companies are credited for all cash forwarded to Charlotte Mills, Incorporated. The selling companies on their books credit Charlotte Mills and charge Accounts Receivable Control account for all sales made to customers; a subsidiary ledger is kept by the selling companies for the customers' accounts.

Letters were sent to the three selling companies asking them to confirm the balances owing to Charlotte Mills, Incorporated, at June 30, 1924, and to mail the confirmations to your office. The companies were also requested, if the balances on the Charlotte Mills books did not agree with their balances, to send you a detailed analysis of their account for the month of June.

The Textile Selling Corporation and the Textile Foreign Export Corporation balances agreed with the balances on the Char-

¹ See Part II of the Problem, pp. 83 to 87.

lotte Mills books. The analysis of the Cotton Products Company's account with Charlotte Mills, as received from that company, is as follows:

ACCOUNTS PAYABLE - CHARLOTTE MILLS, INCORPORATED

Balance May 31, 1924	\$	898,567.40	
Purchases - Week ending June 7		195,309.11	
" " " " 14		201,847.96	
" " " " 21		254,609.13	
" " " " 28		126,941.32	
Payments - June 3	\$	14,000.00	
" " 4		33,051.98	
" " 11		14,500.00	
" " 14		29,680.51	
" " 17		16,940.85	
" " 20		20,050.00	
" " 24		26,450.27	
" " 26		34,526.11	
" " 29		46,087.03	
Balance		1,441,988.17	
		<u>\$1,677,274.92</u>	<u>\$1,677,274.92</u>
Balance June 30, 1924			<u>\$1,441,988.17</u>

An analysis of the Cotton Products Company's account on the Charlotte Mills books is given below:

ACCOUNTS RECEIVABLE - COTTON PRODUCTS COMPANY

Balance May 31	\$	928,383.42	
Sales - Week ending June 7		195,309.11	
" " " " 14		201,847.96	
" " " " 21		254,609.13	
" " " " 28		126,941.32	
Sales June 30		10,711.60	
Cash received - June 2	\$	29,816.02	
" " " 4		14,000.00	
" " " 5		33,051.98	
" " " 12		14,500.00	
" " " 16		29,680.51	
" " " 18		16,940.85	
" " " 21		20,050.00	
" " " 25		26,450.27	
" " " 27		34,526.11	
" " " 30		46,087.03	
Balance		1,452,699.77	
		<u>\$1,717,802.54</u>	<u>\$1,717,802.54</u>
Balance June 30, 1924		<u>\$1,452,699.77</u>	

An analysis of the sales recorded to have been made to the Cotton Products Company as of June 30 shows shipments charged to that company as follows:

<u>Sales No.</u>	<u>Date Shipped</u>	<u>Date of Order</u>	<u>From Mill</u>	<u>Style of Cloth</u>	<u>Yards</u>	<u>Price</u>	<u>Amount</u>
703851	6/30	6/28	Arlington	PA	20,000	\$0.06	\$ 1,200.00
703852	7/2	6/30	Charlestown	PD	17,940	.14	2,511.60
703853	6/30	6/29	Boston	SF	30,000	.14	4,200.00
703854	7/3	6/30	Boston	PD	20,000	.14	2,800.00
					<u>87,940</u>		<u>\$10,711.60</u>

Physical inventories were taken as of the close of business at June 30, 1924. From these reconciliations and the analysis of the June 30 charges to the Cotton Products Company, proper adjustments were made.²

Charlotte Mills, Incorporated assumes the credit risks for sales; past experience has shown that about $\frac{1}{2}$ of 1% of the yearly sales are uncollectible. The practice has been to keep all bad and doubtful accounts on the books until the close of the fiscal year; the auditor then writes off all bad items and sets up a reserve to provide for estimated inability to collect accounts receivable balances outstanding.

The general auditor of the company has in his possession a list of the customers' accounts included in the June 30 balances which are considered bad or doubtful. These totals for the three selling companies are as follows:

	<u>Bad</u>	<u>Doubtful</u>
Cotton Products Company	\$13,956.09	\$1,500.00
Textile Selling Corporation	12,050.50	2,790.50
Textile Foreign Selling Corporation	2,110.00	
	<u>\$28,116.59</u>	<u>\$4,290.50</u>

Since these selling companies and Charlotte Mills, Incorporated are so closely affiliated, the company's general auditor exercises a very close supervision over the credit departments of these companies in so far as the accounts receivable relate to sales of Charlotte Mills' products; he certifies to you that the totals of bad and doubtful accounts given above are correct. Accordingly you write off the bad accounts, and adjust the provision for uncollectible accounts to meet all anticipated losses.

² The verification and adjustment of the inventories will be presented as Part V of the Problem (page 152). The Federal Reserve Board in "Verification of Financial Statements," states that nothing should be included in the inventory "which has been sold and billed and is simply awaiting shipment" (par. 55 [1]).

ACCOUNTS RECEIVABLE - OPERATING OFFICE

Waste Products Corporation	\$ 4,020.25
P. J. Smith	150.00 ³
John Doe Company	3,607.20
White Pillow Company	490.56
F. L. Fox Co.	1,907.22
The Waste Sales Corporation	826.19
Black & White Co.	156.93
Machinery Scrap Corporation	4,795.85
	<u>\$15,654.20</u>

All accounts are considered good except that of The Waste Sales Corporation, which is thought uncollectible, and that of the Black & White Co., which is considered doubtful. The Machinery Scrap Corporation paid \$2,000 on July 11, 1924; no other payments had been received at the time of your audit.

Cotton Claims

These are claims made for inferior or lost cotton shipments. The balances are as follows:

Cotton Sales Co.	\$ 4,913.06
J. J. Loftus, Jr.	6,326.09
Shepard & Jones	1,916.40
N. Y., N. H. & H. R. R. Co.	9,496.50
Albany & Randolph Co.	3,621.14
	<u>\$26,723.19</u>

All have been paid during July except the claim against the N.Y., N.H. & H. R.R. Co. which is of two years' standing; a reserve of \$10,000 had previously been set up to cover this claim.⁴ The cash received was traced into the cash book.

J. R. Hand Co.

The balance of \$4,265.20 is owed Charlotte Mills, Incorporated because of loss from the cancellation of a contract for special goods which could not be sold. It is in process of litigation and the company expects to collect the full amount.

Criticize constructively the verification procedures outlined above; should any additional verification be made? Prepare in

³ Credit balance.

⁴ The verification and scheduling of the Reserve for Bad Debts and the Reserve for Cotton Claims should be made a part of this assignment.

summary form all schedules needed for purposes of a balance sheet or limited-test audit.⁵

PROBLEM 27

GOODWIN, MISHEL & PRICE, INC.

Cuban Accounts Receivable

Goodwin, Mishel & Price, Inc., New York, N. Y., carry on an export business specializing in the shipment of cotton goods and similar products. The company shipped ten bales of cotton goods to the San Pedro Company, Havana, Cuba, during July, 1927, terms C.I.F. The San Pedro Company became financially embarrassed before the arrival of the merchandise in Cuba and was unable to accept the goods. It therefore canceled the order. Goodwin, Mishel & Price, Inc. billed the San Pedro Company, however, for the agreed selling price of \$10,000, plus freight and insurance charges of \$1,500. This amount, \$11,500, you find included in the accounts receivable at the time of your annual audit, as of September 30, 1927, of the accounts of Goodwin, Mishel & Price, Inc.

You ascertain, from your inspection of the company's permanent inventory records, that the cost of the merchandise shipped to the San Pedro Company was \$7,500; on the basis of current quotations its present market value in New York is approximately \$7,000. You are informed, moreover, that there is no market in Cuba for these particular goods. Goodwin, Mishel & Price, Inc. maintain, however, that the amount of the account receivable is good and that it will be collected in full, even though suit is necessary.¹

⁵ See Jackson, *Audit Working Papers*, pp. 92-98, and Appendix A; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 106-127; Bell, *Auditing*, pp. 121-147; Cole, *Accounts: Their Construction and Interpretation*, pp. 67-69, 116-118; *Journal of Accountancy*, November, 1927, pp. 321-333.

¹ "When sales of goods to be exported are paid for in advance, or at time of shipment, no question arises as to the period in which the profit should be taken. When goods are shipped to foreign customers against open drafts, it may be inadvisable to anticipate the profit, because it frequently happens that drafts are not honored and the goods must be resold.

"There can be no fixed rule which will cover all cases. Good accounting practice permits one of two methods: (1) When the goods are not paid for in cash, and if there is some doubt that the goods will be paid for, the export concerns may carry the goods as part of

How should this situation be reflected in the accounts of the company which you are to certify?

PROBLEM 28

JOHNATHAN WELLS, INC.

Repurchase of Accounts Receivable Sold

The accounts of Johnathan Wells, Inc. are audited annually by Messrs. Johns & Williams, Certified Public Accountants. With reference to the audit for the fiscal year ended December 31, 1927, it was ascertained that the company had sold \$50,000 of accounts receivable and \$100,000 of preferred stock during December. In the case of both of these items, the president of Johnathan Wells, Inc. assured the accountants that the sales were absolutely bona fide, with no obligation or intention on the part of the company to take either one back into its assets. As a result the balance sheet was certified without comment being made on these features.

A copy of this certified balance sheet was submitted to the bank with which the company carried a considerable line of credit. Sometime later the bank ascertained that the company had bought back all of the receivables and preferred stock which had been sold during December; as a reason for the first action the company stated that it did not want its customers to know that it had assigned any of their accounts, and for the second action it stated that it did not wish the books to show that any of the preferred stock had been sold for less than par, which had actually been the case in this particular instance. In fact, the bank ascertained that these contra transactions were consummated before the results of the audit had been published.

The president of the bank thereupon discussed with Mr. Williams, one of the partners in the firm of Johns & Williams, the ethics of these transactions; the banker maintained that although the balance sheet as certified might technically be correct, never-

their inventories priced at their actual value on the spot where they happen to be. (2) When there is little doubt about the collection of the proceeds of the drafts and ample reserves are created for doubtful accounts, such shipments may be treated as sales and the uncollected proceeds may be treated as accounts receivable at their net value."—Montgomery, *Auditing Theory and Practice*, 3rd ed., Vol. I, p. 104.

theless it was distinctly misleading as it did not thoroughly reflect the condition of the company as a going concern and to that extent would serve to deceive the bank. To this Mr. Williams replied that in the case of a bona fide sale, even of items of this nature, he would not feel called upon to comment upon it in his certificate; the banker replied that such an attitude on the part of an accountant meant that henceforth the bank would always have to go behind an audit to see if there was anything there which it did not know about.

In this particular instance, however, and in view of subsequent happenings, Mr. Williams agreed with the president of the bank; he wrote a letter to the president of Johnathan Wells, Inc., stating that the practices which the corporation had indulged in were nothing more nor less than "window dressing" and that in the future his firm could not certify to a balance sheet under such circumstances without comment.

Were the accountants in error in certifying without comment the balance sheet of Johnathan Wells, Inc.? Was the president of the bank justified in making the criticisms which he made? Discuss all points involved.

Part IV—Asset Verification: Inventories

PROBLEM 29

THE WOOD COMPANY

Examination of Physical Retail Inventory

The Wood Company, which owned shoe stores in several cities in the southern section of the United States, decided early in 1925 to purchase the Brooks Shoe Store in New Orleans. Messrs. Cooper and Fulton, Certified Public Accountants, were engaged by The Wood Company to verify the assets and liabilities, and to make a general survey of earnings, management, organization, and so forth, of the Brooks Shoe Store.

As a part of the asset verification, a physical inventory was taken by the regular store employees, which inventory was to be tested by the accountants. Serially numbered, duplicate inventory slips¹ for each class and grade of merchandise, giving

¹ The inventory slips were 4"x4" cards, in the form given below:

247				
INVENTORY				
Quantity	Style No.	Description	Unit Price	Total Value
16	8730	Pumps	9.50	
Counted by <u>E. F. C.</u>				

The serial numbers were printed on the slips. The style number, description, and price had been filled in in advance. The clerks filled in the quantity and initialed the sheets.

descriptions, which in most cases consisted of style numbers, were prepared in advance by the clerks. As the count of a lot was completed the quantity was marked on the corresponding ticket. The original was retained by the stock-taker and the duplicate was placed under the last box of the lot. Thus the lots were separated from each other by these inventory slips. The inventory of accessories, such as fancy buckles, laces, and polish, was taken by trays and drawers.

Articles on display on racks, in show-cases and in the windows were given separate inventory slips. In a number of instances only one of a pair of shoes was on display. The boxes containing the other halves of these pairs were kept in a special section.

The shoes and rubbers were kept in boxes on shelves both in the showroom and in the storeroom. When a pair was sold it was customary to invert the box which had contained them; a box upside down, then, indicated that that box was empty. In the case of children's shoes, especially in the very small sizes, it was common to have two, and sometimes three, pairs in a box.

The examination of the inventory was made on a Saturday night after the store had closed. The proprietor, Mr. William Brooks, was present, as well as two members of the Wood Company, sons of Mr. Wood. Representing the accounting firm were six juniors in charge of a senior; the accountants arrived shortly before the clerks had completed their counts. They were to test the accuracy of the count, both as to quantity and description. Any errors were to be noted on the duplicate slips left by the clerks. In case of gross error or doubt the juniors were to call either the senior in charge, or the head of the department who was to remain until the accountants completed their check. After having completed their check the assistants were to deliver all the slips to the senior in charge. Later these tickets would be compared with the inventory list prepared by the Brooks Shoe Store from the count of the clerks.

In checking the store count each junior assistant was assigned a definite section of the shelves in which boxes right-side-up were counted and compared with the number set down by the clerks. As a test, the description or style number on a few of the boxes were then compared with those on the slips, always noting the first and last boxes in each lot. Next, the section

was gone through again; about one-third of the right-side-up boxes were pulled part way out and gently shaken to make certain that the boxes were filled. Occasionally empty boxes were found. Occasionally, also, the contents were examined to be sure that they agreed with the markings on the boxes.

While engaged in making these tests some of the junior assistants were approached individually by the sons of Mr. Wood who were somewhat officious and seemingly desirous of showing authority. One junior was told, after he had counted the right-side-up boxes, that "this is no way to take an inventory; you should examine the contents of all boxes." The junior explained that he had not completed his check of that lot; he then went back over it and tested nearly all the boxes to be sure they were full. This did not satisfy Mr. Wood who reiterated that the contents of each box should be examined. Mr. Wood stated that he was buying this stock and that he was there to see that he was not cheated. By this time the senior accountant was attracted to the scene; he drew Mr. Wood to one side and explained to him that the assistants were working under orders that had been prepared previously in conference with his, Mr. Wood's, father. The senior then instructed all the juniors to continue the examination as originally instructed, and to refer all questions to him.

The clerks' count of infants' shoes was generally in excess of the number of boxes. This resulted from having more than one pair in many of the boxes. Accordingly, all boxes of infants' shoes were opened and a complete count made; the results were generally slightly different from that made by the clerks. In making this careful check a number of instances were found where there were not complete pairs; for example, in one group that called for 20 pairs there were found 40 shoes consisting of 23 rights and 17 lefts. Only complete pairs were accepted for the final inventory.

The number of shoes on display was relatively small; the boxes in the special place were counted and found to agree with the single shoes on display for which tickets had been made out. No detailed examination of these boxes was made.

A rough check of laces, polish, and such small items was made, the junior merely scrutinizing the drawer and estimating the

quantity there. If his estimate came at all near the figure set down by the clerks the slip was passed. Buckles, however, because they were comparatively expensive, were checked in considerable detail.

The checking was completed about 11 P.M., the duplicate slips were gathered together, all accounted for and arranged by groups. The senior placed these slips in his brief case, to be retained by him until the inventory verification had been entirely completed.

Comment upon the verification.

PROBLEM 30

CHARLOTTE MILLS, INCORPORATED—PART V

Verification of Inventories

The work of preparing the inventories for the annual audit was completed soon after you began your work on August 1; a summary of book inventories at June 30, 1924 was handed you by the comptroller, as follows:¹

SUMMARY OF INVENTORIES

Finished Inventory:		
Gray Cloth	\$ 844,277.15	
Bleached and Finished Cloth	918,524.61	\$1,762,801.76
Process Inventory:		
Cloth	\$912,397.38	
Waste	9,301.75	921,699.13
Raw Cotton:		
Cotton on Hand	\$1,389,667.19	
Less Inventory Reserve	52,120.60	1,337,546.59
Stores and Supplies		500,679.82
Total Inventories		<u>\$4,522,727.30</u>

Shortly after beginning the audit you were also informed that the detailed inventory records were ready for you at any time you desired to take up that part of the verification. During your

¹ These closing inventories were referred to by totals in Part I of this problem (page 80), in order that the student might proceed to draw up his working balance sheet for the conduct of the audit. The student should realize that the amount of detail work in the verification of this inventory is very much greater than can feasibly be presented here. The inventory would be represented by perhaps hundreds of inventory cards and by scores of sheets of items, in addition to the summaries shown in the following pages. See Montgomery, *Auditing Theory and Practice*, 3rd ed., Vol. II, pp. 124-130.

previous audits you had ascertained the general inventory customs of the textile industry, and had also carefully noted the practices with regard to inventories of this particular company.

Finished Cloth Inventory—General Information

In the textile industry "Gray Cloth" is considered finished cloth. Gray cloth is the unbleached cotton cloth as taken from the looms. In the Charlotte Mills inventories not only gray cloth, but also cloth in all stages of bleaching and finishing is considered finished cloth.

Cloth is described in textile papers, in sales advertisements to the trade, and in actual inventories by symbols; the following may be considered as typical:

PD 39 — 80/80 4.00

The capital initials, "PD," stand for the style; "39" means that the cloth is 39 inches wide; "80/80" indicates that there are eighty threads each way to an inch of cloth; and, "4.00" means that 4 yards of cloth weigh one pound.

Accounting Procedure

Two main book inventories of finished cloth are kept, one for gray cloth and one for bleachery cloth. Separate records are kept for each kind of cloth, as follows: (1) gray cloth book, and (2) bleachery cloth book.

The gray cloth book is divided into sections for each mill and each mill section is further subdivided into accounts for the several styles of cloth produced by the mill. The accounts show the cloth yardage only; no dollar value is expressed, and thus the book in substance is a permanent inventory record solely. The ruling of this book is shown on page 154.

Each mill furnishes the accounting department with a weekly production report; this shows each style and number of yards of each style produced. These reports furnish the data for the debit entries in the gray cloth book. The selling companies send triplicate sales memoranda for each sale to the Boston office. The official in charge of the sales, after consulting his inventory records, decides from which mill the order will be filled and enters the name of the mill on the sales memoranda; one of the copies

is then sent to the bookkeeper who keeps the gray cloth book. This record supplies the information for the "credit" under the caption of Sales.

If gray cloth is to be bleached or dyed, the mill transferring cloth to the bleaching and finishing departments sends a transfer memorandum to the Boston office; on this is reported the style and yardage of cloth transferred. This memorandum furnishes the "credit" under "transfers to bleachery." The gray cloth book is balanced in pencil daily; every three months it is ruled up and the balance brought down in ink.

At the end of each three months' period the cost department furnishes a list of cost prices. This list shows the mill, the style and the cost price for the production of the quarter. These cost figures, when applied to the balances of yardage per the books, give the monetary value of the book inventory; the yardage produced in former quarters and still on hand, as explained below, is valued at its cost price.

MILL.....			SHEET No.....					
STYLE.....								
DEBITS			CREDITS					
PRODUCTION			SALES			TRANSFERS TO BLEACHERY		
Date	Report No.	Yards	Date	Sales Memo No.	Yards	Date	Memo No.	Yards

A Page from the Gray Cloth Book

It is assumed that the oldest cloth on hand is sold first. At the end of each quarter, in bringing down the balances of yardage on hand, the sales for the three months are totaled and compared with the inventory balances at the beginning of the period. If the inventory for any grade of cloth for any mill at the beginning of the period has been entirely sold, then only one balance, that

of yards produced during the current period and unsold, is brought down. But if the yardage of cloth on hand at the beginning of the period exceeds the yardage sold during the period, the excess of such beginning inventory over the sales of the period is brought down as one balance, while the yardage produced during the current quarter is brought down as a second balance. The cost prices of the previous period are then applied to the old yardage on hand, while the cost figures of the current period are applied to current production. Practically, balances of cloth on hand never run back further than one period beyond the current three months; at June 30, 1924, all balances of gray cloth on hand were manufactured during the quarter ending that date.

All cloth is produced for "stock" and all orders are filled from stock; the company had learned from experience that special order goods did not pay, and had discontinued them entirely.

Bleachery Cloth Book

The bleachery cloth book is likewise divided into sections for each mill. Each mill section is then subdivided into sections for each style of gray cloth produced, and each of these sections, in turn, has an account for the style of finished cloth. This means that each style of gray cloth may be finished in any one of several different styles. A sample page of this book is as follows:

MILL.....						No.....				
GRAY STYLE.....						FINISHED STYLE.....				
GRAY				FINISHED			SALES			
Date	Transfe Memo No.	Yards		Date	Case No.	Yards	Date	Sales Memo. No.	Case No.	Yards
		Dr.	Cr.							

When a transfer memorandum is issued by any mill to transfer gray cloth to a bleaching or finishing department, it is used

for posting the yardage of gray cloth transferred to the Yards, Dr. column under the "Gray" caption in this book. When the finishing department completes the finishing (or bleaching) of a quantity of cloth, it sends a *packing report* to the inventory department. This report gives the name of the mill, and the style and yardage of gray cloth which has been finished; it also gives the total yards finished, together with the case numbers and yards packed to each case. This packing report furnishes the information from which the credits are made to Gray Cloth and the debits to Finished Cloth. Each case of finished cloth is entered separately.²

The sales memorandum, described with reference to the gray cloth book, furnishes the information for posting to the sales part of the ledger pages. At the end of each quarter the balances of gray and finished cloth are brought down in their respective sections; the gray cloth balance in each account is the difference between the yardages entered in the debit and credit columns, whereas the finished cloth balance in each account is represented by the unsold cases. For inventory purposes a list of these yardages is prepared; the cost prices furnished by the cost department are then applied to these totals to obtain the value of the inventories.

Verification of Finished Cloth Inventories

The following inventory summaries of finished cloth have been prepared by the company from the cloth inventory books:

² In practice, there is a gain or loss in finishing cloth, so that the total yards finished is different from the yards of gray cloth used. For this problem, however, such gains or losses may be disregarded.

INVENTORY SUMMARY OF GRAY CLOTH BOOK, JUNE 30, 1924

Mill	Style	Construction			Yards on hand 6/30/24	GRAY CLOTH Cost Price per yard	GRAY CLOTH Cost Value
Arlington	PA	25	56/44	10.55	96,281	\$0.05500	\$ 5,295.46
	PB	27	44/44	9.50	116,024	.06250	7,251.50
	PC	38½	64/60	5.35	108,954	.11000	11,984.94
	PD	39	80/80	4.00	82,006	.12750	10,455.76
	PE	39	96/100	5.00	51,010	.21000	10,712.10
	SF	36	64/68	3.50	9,806	.13500	1,323.81
					464,081		\$ 47,023.57
Boston	PA	25	56/44	10.55	410,660	.04875	\$ 20,019.68
	PD	39	80/80	4.00	1,161,205	.12750	148,056.64
	SF	36	64/68	3.50	1,094,219	.13000	142,248.47
	PCA	36½	72/80	4.70	176,420	.12500	22,052.50
					2,842,504		\$332,377.29
Cambridge	PD	39	80/80	4.00	8,420	.13000	\$ 1,094.60
	SF	36	64/68	3.50	11,050	.14250	1,574.63
	PCA	36½	72/80	4.70	34,719	.12000	4,166.28
	CLA	40	96/100	7.00	29,024	.18750	5,442.00
					83,213		\$ 12,277.51
Charlestown	PD	39	80/80	4.00	71,921	.13778	\$ 9,909.28
Dorchester	CLA	40	96/100	7.00	616,719	.19250	\$118,718.43
	CALA	40	80/76	6.00	897,410	.15000	134,611.50
					1,514,129		\$253,329.93
Melrose	SA	39	96/100	4.50	426,519	.27000	\$ 115,160.13
Woburn	SA	39	96/100	4.50	170,984	.27250	\$ 46,593.14
	PE	39	96/100	5.00	81,020	.20850	16,892.67
	CLA	40	96/100	7.00	56,019	.19125	10,713.63
					308,023		\$ 74,199.44
		Totals			5,710,390		\$844,277.15

INVENTORY SUMMARY OF BLEACHERY CLOTH BOOK, JUNE 30, 1924

Mill	Style	Finish	Yards 6/30/24	COST PRICES			Amount
				Gray Cloth	Finishing Cost	Total Cost per yd.	
<u>GRAY INV.</u>							
Boston . . .	SF		506,500	\$0.13000		\$0.13000	\$ 65,845.00
Dorchester .	CLA		400,000	.19250		.19250	77,000.00
Arlington . .	PA		80,200	.05500		.05500	4,411.00
Boston . . .	PA		198,000	.04875		.04875	9,676.88
	PD		100,250	.12750		.12750	12,781.87
Woburn . . .	CLA		897,620	.19250		.19250	172,791.85
					Finishing Charges in Process		\$342,506.60
							71,804.06 ³
			2,182,570				\$414,310.66
<u>FINISHED INV.</u>							
Arlington . .	PA	Bleach	350,500	.05500	\$0.01750	.07250	\$ 25,411.25
Boston . . .	PA	Bleach	490,000	.04875	.01750	.06625	32,462.50
	PA	B. & Print	2,180,400	.04875	.04675	.09550	208,228.20
	PD	B. & Print	1,360,640	.12750	.04750	.17500	238,112.00
			4,381,540				\$504,213.95
			6,564,110				\$918,524.61

³ This amount was added to the book inventory on the advice of the cost department, which listed the actual yardage of gray cloth in the various finishing processes and applied the current production costs to it; in this way the value of finishing work done on gray cloth in process of bleaching was determined. The records of the cost department, together with the records supporting the bleachery cloth book, would be examined sufficiently to satisfy the auditor not only that the yardage of gray cloth in process of bleaching was approximately correct, but also that the finishing charges in process were properly determined. The detail of this verification is not included in this problem.

Physical Inventories

Physical inventories were also taken at June 30, 1924, being summarized by styles of cloth for each mill. An examination of the rough inventory sheets showed that they were properly signed by the various foremen who took the inventory. The summaries, as prepared by the cost department, and showing in detail how the totals were determined, had been given you by the comptroller of the company.

A comparison of the gray cloth book summary with the physical inventory of gray cloth showed the physical inventories to be *over* the book summary by 37,940 yards. This was because the physical inventories included two sales for which shipments were not made until July 2 and 3, but which were posted to the gray cloth book as of June 30.⁴ These sales were as follows:

<u>Sales No.</u>	<u>Date Shipped</u>	<u>Date of Order</u>	<u>From Mill</u>	<u>Style</u>	<u>Yards</u>
703852	7/2	6/30	Charlestown	PD	17,940
703854	7/3	6/30	Boston	PD	20,000

The bleachery cloth book summary agreed with the physical inventory of finished cloth.

After comparing the total yards as shown by the physical inventories with the summaries, the rough inventory sheets were checked to the physical summaries and the footings tested. No discrepancies of importance were found, and the company's figures were accepted.

Pricing the Inventory

Next, the cost prices furnished by the cost department were checked to the book summaries and the extensions verified by thorough tests. The cost system had been examined previously regarding the methods of gathering costs; the methods of reporting cotton used, of distributing labor from the time books, of treating waste in the various departments, and of accumulating and distributing burden you consider give a *commercially* exact cost for each style of cloth produced in each mill.

⁴ While this discrepancy is exactly accounted for here it is much more common in practice to find some difference that cannot be exactly accounted for. See Jackson, *Audit Working Papers*, p. 84, final paragraph; Bell, *Auditing*, pp. 152-157, 169-170.

Market prices for various grades of cloth were obtained from *The Daily News Record*, a daily textile publication, as follows:

GRAY COTTON CLOTH				
Construction of Cloth			Price per Yard	
Width	Threads to Inch	Yards to the Pound	June 30	August 15
25"	56/44	10.55	\$0.05 - .05¼	\$0.05
27"	44/44	9.50	.05½	.05½
38½"	64/60	5.35	.10	.09½
39"	80/80	4.00	.12½	.11¾
39"	96/100	5.00	.22	.21
36"	64/68	3.50	.13¾	.12¾
36½"	72/80	4.70	.11½	.10¾
40"	96/100	7.00	.18 - .19	.18 - .18½
40"	80/76	6.00	.14	.13½
39"	96/100	4.50	.27½	.27

An examination of the sales of the company showed that gray cloth was being sold at approximately the above prices; in the case of two contracts for one million yards each of finished goods (i.e., bleached and printed cloths), styles SA and SF, the sales were made during July and August at from \$0.005 to \$0.03 above the cost prices of the cloth.

The treasurer and comptroller objected to the use of the above market quotations as a test of inventory values at June 30; they argued that these prices were merely used to attract buyers because of the poor market and that no large quantities of cloth would be sold at prices as low as these.

The Cloth in Process Inventory

The inventory of cloth in process at June 30 consisted of the following:

Regular Cloth in Process	\$912,397.38
Waste Inventory	9,301.75
	<u>\$921,699.13</u>

The inventory summary of cloth in process was prepared by the cost department from the physical inventories taken for each mill; it was priced at the weighted average of the June cost prices of all the mills.

This summary, which is shown on the following page, together with the rough inventory sheets signed by the foremen of

the various departments in each mill in which cloth was in process at June 30, was turned over to you by the comptroller.

Department	Pounds in Process	Clean Cotton Cost per lb.	Cost over Cotton per lb.	Total Cost per lb.	Total Value
Opening	185,640	\$0.32000	\$0.00001	\$0.32001	\$ 59,406.66
Picking	412,609	.37647	.00100	.37747	155,747.52
Carding	320,045	.37700	.01100	.38800	124,177.46
Roving	305,600	.37725	.02700	.40425	123,538.80
Spinning	380,400	.37752	.05000	.42752	162,628.61
Warping	302,000	.38000	.05800	.43800	132,276.00
Weaving	342,843	.38100	.07000	.45100	154,622.33
Total	<u>2,249,137</u>				<u>\$912,397.38</u>

The rough sheets resulting from the physical inventory were examined and were checked to the summary for quantities; the summary was found to be correct. Your previous examination of the cost system was sufficient to satisfy you that the prices as determined by the cost department were substantially correct.⁵

The waste inventory summary prepared from the rough inventory sheets and priced at selling prices as of June 30, 1924, is as follows:

Department	Pounds of Waste	Selling Price	Value
Picking	14,726	\$0.08	\$1,178.08
Carding	8,019	.08½	681.62
Roving	6,724	.07	470.68
Spinning	846	.12	101.52
Warping	3,008	.19	571.52
Weaving (rags)	6,027	.09	542.43
Waste Shed	27,059	.10	2,705.90
Consigned	30,500	.10	3,050.00
			<u>\$9,301.75</u>

⁵ The cost price is separated into two parts, namely, the cost of raw cotton, called "Clean Cotton Cost per pound," and "Cost over Cotton per pound." The clean cotton cost per pound is determined by deducting the selling price of waste from the cost of cotton put into process, and by dividing the resultant thus obtained by the pounds of cotton produced and ready for the next process. For example:

Raw cotton put through picking department 1,000 lbs. at \$0.32 = \$320
Pounds of waste sold 200 lbs. at .10 = 20

Value of cotton finished in department \$300

Pounds of cotton finished in department 800

Cost per pound of clean cotton \$300 ÷ 800 lbs. = \$0.375

The cost over cotton per pound consists of the labor and burden costs per pound of cotton finished in any department, plus similar charges for all preceding departments. For example:

Cost over cotton per pound—Opening Department \$0.00001

Cost over cotton per pound—Picking Department 00099

Cost price applied to cotton passed through Picking Dept. \$0.00100

Selling prices for the various grades of waste included above were verified from sales memoranda of June 30, 1924 or thereabouts.

Raw Cotton Inventory

The auxiliary accounting records for raw cotton include:

1. *A contract book* in which are entered all contracts for the purchase of cotton. In this auxiliary record are entered the date and number of the contract, the name of the vendor, and the pounds of cotton contracted for; under a "Remarks" heading is entered the contract price and dates of delivery. When bills of lading are received the quantities shown by these documents are credited against the respective contracts and are charged to the *in-transit book*. At June 30, two contracts were not completed. The balances called for by these open contracts were as follows:

Contract No.	947	180,476 lbs. at	\$0.3126 per lb.
	1001	376,500 lbs. at	.3102 per lb.

2. An *in-transit book* in which all quantities reported as in transit by the bills of lading received are posted as debits and all deliveries are posted as credits. At June 30, 94,500 lbs. at \$0.3107 per lb. was in transit.

3. A *cotton book* in which all deliveries are charged to each mill by pounds and cost price. Each mill is credited weekly for the cotton consumed. At the end of every four weeks an average cost price for cotton on hand is computed. These average prices at June 30 were used to determine the value of the inventory.

4. *Cotton consumed reports* which are made out by the cost department each week and are the basis for the credits to the *cotton book*.

5. Physical inventories from each mill at June 30, 1924.

The entries in the financial accounting records are to debit Cotton Purchases and credit Accounts Payable when the invoice is received from the vendor; this is supplemented or supported by the statistical or auxiliary records described above.

A summary of the physical inventories of raw cotton at each mill on June 30 was as follows:

<u>Mill</u>	<u>Pounds on Hand</u>	<u>Average Cost Price</u>	<u>Value</u>
Arlington	307,709	\$0.3201	\$ 98,497.62
Boston	1,819,889	.3225	586,914.27
Cambridge	233,463	.3200	74,708.25
Charlestown	277,264	.3105	86,090.37
Dorchester	833,044	.3181	264,908.01
Melrose	540,486	.3220	174,036.44
Woburn	328,655	.3180	104,512.23
	<u>4,340,510</u>		<u>\$1,389,667.19</u>
Less: Balance of Inventory Reserves set up June 30, 1923 . . .			52,120.60
			<u>\$1,337,546.59</u>

The physical inventories were found to be in approximate agreement with the *cotton book* balances. Cotton in transit was not included in the above inventory.

The New York spot price at June 30 for the grade of cotton used by this company was \$0.2825 per lb. On August 15 the price was \$0.2486 per lb.

Stores and Supplies

The general auditor furnished you with the following physical inventory summary of stores and supplies at all of the mills, prices at cost and market. The lower total was taken as the value of the inventory. The summary was as follows:

SUMMARY OF STORES AND SUPPLIES

<u>Classification</u>	<u>Cost</u>	<u>Market</u>
Coal	\$117,619.50	\$127,642.26
Fuel Oil	29,726.30	28,914.94
Castings	16,696.06	16,696.06
Size	7,426.39	7,019.21
Starch	6,900.00	7,227.56
Dyes	42,010.09	38,422.25
Bleaching Chemicals	97,983.72	104,609.27
Shipping Materials	38,736.67	36,085.19
Repair Supplies	157,988.05	123,113.88
Lumber	11,623.41	10,949.20
	<u>\$526,710.19</u>	<u>\$500,679.82</u>

A physical inventory from each mill supported the above summary. At each mill the following records are kept:

1. Bin cards in the storerooms showing quantities on hand at the beginning of the year, quantities purchased during the year, quantities issued on requisitions during the period, and balances at June 30, 1924.

2. A supplies inventory book with an account for each class of items; these accounts show the same information as the bin cards, but in addition give the purchase prices and values of each class of items.

3. Requisitions upon which stores had been issued; these are bound up in loose-leaf binders.

The rough inventory sheets were checked to the summaries and the larger items were tested for prices by referring to the latest purchase invoices and to market quotations. The prices and extensions were found to be satisfactory.

Examine critically the verification for the above inventories; is the verification satisfactory? If not, in what respects would you proceed differently? Prepare summary working schedules for your audit working papers; include any adjustment entries which may be necessary.⁶

PROBLEM 31

THE VALKYR COMPANY

Verification of Leather Inventory at Sales Office

The Valkyr Company, Chicago, Illinois, purchased raw hides, processed and tanned them, and sold the leather to shoe and other leather products manufacturers through its main office, and its sales branch in New York. It maintained three warehouses, including the storage space at the sales office in New York; this gave it a combined storage capacity of approximately 6,000 tons of leather. The seven tanneries were located in the middle western part of the United States. As soon as a lot of leather was completed, it was shipped to its Chicago office or to the sales branch in New York, where it was placed in storage. The value of the leather on hand varied from \$3,000,000 to \$5,000,000, depending upon the time of year and the demand for leather.

The pieces of leather were all stamped with identification marks, showing the grade of leather, tannage, etc. Each lot was

⁶ See Federal Reserve Board bulletin, "Verification of Financial Statements," pars. 50-55; Jackson, *Audit Working Papers*, pp. 72-91 and Appendix A, Schedules D-D14; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 143-199; Bell, *Auditing*, pp. 149-180; Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 69-73.

weighed upon its arrival at the warehouse and entries of the description, the number of pieces, and weight were made in the perpetual stock records. The leather was piled in the warehouses according to the kind of leather and the tannery from which it had been shipped. When withdrawals were made to fill an order, the weight was taken and entered in a column for that purpose in the perpetual stock records. The balance in storage was then figured.

At the end of each month, summary inventory sheets were drawn up for each tannery. One per cent was deducted from the gross weight of each lot, as shown by the perpetual inventory sheets, to arrive at the charged weight, because customers were allowed 1% for shrinkage. The company had no figures for the total cost of producing each lot of leather so the market selling price per pound at the end of the month was used in computing the extensions. No physical inventory, however, was taken to check the perpetual stock record except when a particular lot was sold completely. The assistant treasurer of the Valkyr Company, who was also in charge of the accounts at the New York sales branch, stated that few discrepancies were found at such times, and that the book inventory probably did not vary more than a fraction of one per cent from the amount which would be obtained if a complete physical inventory were to be taken. He believed that it was impracticable to take a complete physical inventory because of the expense involved.

During the course of the audit for the year 1923, the executives presented the following summary inventory sheets to the company's auditors, Messrs. Cartwell, Kittredge & Co., Chicago and New York, to substantiate the general ledger inventory figure; the inventory at New York appeared at \$2,905,986.08 in the December 31, 1923 final accounts of the Valkyr Company.¹

¹ While the name of this company is not given, the author nevertheless wishes to express his sincere appreciation to the company's executives for furnishing the following inventory sheets from their own inventories; the company changed the names of the tannages, and has scaled the figures somewhat.

THE VALKYR COMPANY									
At <u>NEW YORK</u> Store.									
Sheet 1									
INVENTORY of <u>HAZELHURST</u> Tannage									
On hand December 31, 192 3									
BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE ¢	AMOUNT			
		<u>Country Hide (Old)</u>							
1 328		Damaged Run	12 440	12 316	26	3 202	16		
551		Dark Run	6 992	6 922	26	1 799	72		
		<u>Country Hide (New)</u>							
20 437		Middle Run	313 979	310 839	36	111 902	04		
17 586		Light Run	192 337	190 414	34	64 740	76		
13 997		Damaged Run	163 445	161 811	30	48 543	30		
169		Scabs	1 969	1 949	18	350	82		
5		Pieces	32	32	10	3	20		
730		Dark Run	8 013	7 933	30	2 379	90		
84		Chicks	664	657	30	197	10		
1 255		Light Run (Harness)	28 280	27 997	34	9 518	98		
4		Russett "	42	42	34	14	28		
<u>BENDS</u>									
50		Scotia #1	328	325	43	139	75		
25		Badger #1	203	201	43	86	43		
<u>CROPS</u>									
381		Damaged Run	5 255	5 202	32	1 664	64		
1		Bull	16	16	32	5	12		
1		Scabs	12	12	27	3	24		
18		Russett Harness	247	245	32	78	40		
2 751		Run	39 258	38 863	32	12 436	16		
200		Strips	2 899	2 870	30	861	00		
59 573			776 409	768 646		257 927	00		

THE VALKYR COMPANY

Sheet 2

At NEW YORK Store.

INVENTORY of HAZELHURST Tannage

On hand December 31, 1923

BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE ¢	AMOUNT
		<u>Cuban Country Hide</u>				
3 785		Middle Run	59 730	59 133	32 "	18 922 56
12 606		Light Run	132 187	130 865	30 "	39 259 50
5 616		Damaged Run	51 297	50 784	25 "	12 696 00
1 417		Bulls	27 821	27 543	30 "	8 262 90
38		Damaged Bulls	829	821	25	205 25
		<u>SALADERO OX HIDE</u>				
526		Plump Run	10 179	10 077	33	3 325 41
1 496		Middle Run	22 796	22 568	33 "	7 447 44
21		Bulls	479	474	32	151 68
		<u>Packer Steer Hide</u>				
3 159		Plump Run	63 327	62 694	40 "	25 077 60
1 584		Middle Run	24 653	24 408	39 "	9 518 34
7 055		Light Run	86 640	85 774	36 "	30 878 64
3 339		Damaged Run	53 640	53 104	33 "	17 524 32
735		Bulls	17 223	17 051	32 "	5 456 32
3		Scabs	45	45	18	8 10
1		Pieces	10	10	10	1 00
		<u>Rio Grande & Campiano Ox Hide</u>				
2 567		Plump Run	52 246	51 724	38 "	19 655 12
12 766		Middle Run	202 776	200 748	36 "	72 269 28
3 670		Light Run	43 437	43 003	32 "	13 760 96
3 361		Damaged Run	41 478	41 061	31 "	12 728 91
1 720		Bulls	38 201	37 819	32 "	12 102 08
12		Scabs	165	163	18	29 34
65 477			929 157	918 867		309 280 75

THE VALKYR COMPANY									
At <u>NEW YORK</u> Store.									
Sheet 3									
INVENTORY of <u>HAZELHURST</u> Tannage									
On hand <u>December 31,</u> 192 <u>3</u>									
BACKS	BDLS.	SELECTIONS	INSPECTION WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE ¢	AMOUNT			
2 955		Md Run Country	45 820	45 362	32	14	515	84	
19 052		Lt Run	-217 106	214 935	30	64	480	50	
6 511		Dgd Run	81 969	81 149	25	20	287	25	
15 763		Bulls	310 617	307 511	30	92	253	30	
93		Scabs	1 509	1 494	18		268	92	
61		Run	600	594	30		178	20	
14		Pieces	188	186	10		18	60	
213		Dgd Bulls	4 175	4 133	27	1	115	91	
<u>SIDES</u>									
7		Pieces	42	42	10	4	20		
<u>BENDS</u>									
49		Plp Run	588	582	38		221	16	
2		Bulls	40	40	38		15	20	
		Ty Bellies	1 599	1 583	13		205	79	
		Store Shoulders	46 400	45 936	20	9	187	20	
		Bull Bellies	38 608	38 221	13	4	968	73	
		Head Pieces	163	161	10		16	10	
44 720			749 424	741 929		207	736	90	

THE VALKYR COMPANY									
At NEW YORK Store									
Sheet 4									
INVENTORY of MAPLETON Tannage									
On hand December 31, 1923									
BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE	AMOUNT	
		<u>PACKER STEER HIDE</u>							
	585	Plump Run	13	202	13	070	40	5	228 00
34	936	Middle Run	549	554	544	058	39	212	182 82
9	401	Light Run	115	766	114	608	36	41	258 88
4	416	Damaged Run	61	983	61	363	33	20	249 79
	345	Bulls	6	024	5	964	32	1	908 48
	33	Scabs		459		454	18		81 72
	100	Dark Run	1	722	1	705	30		511 50
	9	Pieces		50		49	10		4 90
		<u>RIO GRANDE HIDE</u>							
3	936	Plump Run	76	729	75	962	38	28	865 56
5	424	Middle Run	85	314	84	461	36	30	405 96
2	852	Light Run	35	079	34	728	32	11	112 96
2	606	Damaged Run	44	109	43	668	31	13	537 08
	43	Bulls	2	161	2	139	32		684 48
	32	Scabs		594		588	18		105 84
		<u>CROPS</u>							
	505	<u>Havana Packer</u>							
		Run	7	819	7	741	30	2	322 30
		<u>BENDS</u>							
	45	<u>Store</u>							
		Run		640		634	45		285 30
		Shlds Packer Steer	4	053	4	012	24		962 88
		Shoulders Rio Grande	19	599	19	403	19	3	686 57
		Bellies	43	940	43	501	16	6	960 16
		Bull Bellies		537		532	13		69 16
		Heads	3	574	3	538	10		353 80
65	268		1,072	908	1,062	178		380	777 94

THE VALKYR COMPANY Sheet 5 At <u>NEW YORK</u> Store. INVENTORY of <u>MAPLETON</u> Tannage On hand <u>December 31,</u> 192 <u>3</u>									
BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE	AMOUNT			
		<u>Country</u>							
	621	Middle Run	8 729	8 642	32	2	765	44	
1	777	Light Run	18 499	18 314	30	"	5 494	20	
	6	Bull	135	134	30		40	20	
		<u>BAHIA</u>							
1	463	Light Run	16 300	16 137	26		4 195	62	
	579	Damaged Run	7 065	6 994	26		1 818	44	
	75	Bull	818	810	23		186	30	
	40	Damaged Bulls	674	667	20		133	40	
	16	Scabs	552	546	18		98	28	
		<u>City Butchers Matadero Cows & Finnigan</u>							
3	599	Middle Run	55 318	54 765	34	"	18 620	10	
5	789	Light Run	66 536	65 871	32	"	21 078	72	
2	567	Damaged Run	48 076	47 595	28	"	13 326	60	
	486	Bulls	11 044	10 934	32		3 498	88	
	1	Scabs	12	12	18		2	16	
1	010	Dark Run	11 744	11 627	28		3 255	56	
	871	Run	12 023	11 903	32		3 808	96	
		<u>Old Packer Cow</u>							
	482	Light Run	9 528	9 433	30		2 829	90	
1	873	Dark Run	23 703	23 466	26	"	6 101	16	
		<u>Branded Cow New</u>							
9	895	Middle Run	157 993	156 413	36	"	56 308	68	
71	483	Light Run	802 567	794 541	34	"	270 143	94	
11	968	Damaged Run	143 098	141 667	30	"	42 500	10	
	65	Bulls	1 087	1 076	32		344	32	
	8	Scabs	87	86	18		15	48	
114	674		1,395 588	1,381 633			456 566	44	

THE VALKYR COMPANY

Sheet 6

At NEW YORK Store.INVENTORY of MAPLETON TannageOn hand December 31, 1923

BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE ¢	AMOUNT		
4 407		Md Run Brd. Cow	67	134	66	463	36	"	23	926 68
11 146		Lt Run	125	045	123	795	34	"	42	090 30
4 154		Dgd Run	50	741	50	234	30	"	15	070 20
1		Scabs		7		7	18			1 26
13 313		Plp Run Pkr.Str.	262	544	259	919	40	"	103	967 60
16 064		Md Run	256	233	253	671	39	"	98	931 69
3 335		Lt Run	42	741	42	314	36	"	15	233 04
2 717		Dgd Run	47	844	47	366	33	"	15	630 78
167		Bulls	4	423	4	379	32		1	401 28
116		Scabs	2	028	2	008	18	"		361 44
404		Ty Dgd Run	6	862	6	793	33		2	241 69
		Heads	15	348	15	195	10		1	519 50
		Bellies		643		637	16			101 92
		Dgd Bellies		189		187	13			24 31
55 844			881	782	872	968			320	501 69

THE VALKYR COMPANY									
Sheet 7									
At <u>NEW YORK</u> Store.									
INVENTORY of <u>SHELOCTA</u> Tannage									
On hand <u>December 31,</u> 192 <u>3.</u>									
BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE ¢	AMOUNT	
19 626		Plp Run Pkr.Str.	392	490	388	565	40	~ 155	426 00
10 158		Md Run	158	492	156	907	39	~ 81	193 73
7 472		Lt Run	92	168	91	246	36	~ 32	848 56
6 850		Dgd Run	110	663	109	556	33	~ 36	153 48
301		Bulls	7	265	7	192	32		2 301 44
59		Scabs		925		916	18		164 88
482		Ty Dgd Run	7	378	7	304	30	~ 2	191 20
977		Special Lt Run	12	271	12	149	36		4 373 28
127		Md Run Camp Ox	2	345	2	322	35		812 70
<u>BENDS</u>									
1		Bull		15		15	46		6 90
		Shoulders	3	451	3	416	24		819 84
		Bellies	25	778	25	520	16	~ 4	083 20
		Heads	4	228	4	186	13		544 18
46 053			817	469	809	283		300	919 39

THE VALKYR COMPANY

Sheet 8

At NEW YORK Store.

INVENTORY of SHELOCTA Tannage

On hand December 31, 1923

BACKS	BDLS.	SELECTIONS	INSPECTION WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE ¢	AMOUNT
	121	Md Run Brd. Cow	2 050	2 029	36	730 44
5	096	Lt Run	48 667	48 180	34	16 381 20
1	755	Dgd Run	18 954	18 764	30	5 629 20
	88	Scabs	1 071	1 060	18	190 80
	34	Wet	439	435	30	130 50
	689	Chicks	5 163	5 111	30	1 533 30
1	026	Md Run Nat. Cow	17 793	17 615	37	6 517 55
8	172	Lt Run	97 282	96 309	35	33 708 15
2	939	Dgd Run	33 552	33 216	30	9 964 80
	2	Bulls	49	49	32	15 68
	21	Scabs	257	254	18	45 72
	79	Chicks	789	781	30	234 30
	40	Wet	527	522	30	156 60
		Shoulders	5 583	5 527	23	1 271 21
		Bellies	96 557	95 591	16	15 294 56
		Dgd Bellies	1 404	1 390	12	166 80
20	062		330 137	326 833		91 970 81

THE VALKYR COMPANY							Sheet 9		
At <u>NEW YORK</u> Store.									
INVENTORY of <u>SHELOCTA</u>							Tannage		
On hand <u>December 31</u>							<u>1923</u>		
SIDES	BDLS.	SELECTIONS	INSPECTION WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE ¢	AMOUNT	
		<u>OFFAL</u>							
		Tape Pieces		284		281	29		81 49
		X Middleweight Strips		463		458	72		329 76
		Ever Dry Strips	1	588	1	572	56	~	880 32
		A Strips		110		109	57		62 13
		B Strips		190		188	35		65 80
		Butt							
		Branded Strips		203		201	35		70 35
		Branded Strips		477		472	35	~	165 20
		Branded Light Strips		201		199	30		59 70
		Branded Shoulders "		207		205	30		61 50
		Butt Pieces		221		219	30		65 70
		Butt Pieces		405		401	30		120 30
		#1 Strips		341		338	67		226 46
		Clear Bend Pieces	2	286	2	283	65	~	1 470 95
		Branded Bend Pieces	1	368	1	354	40		541 60
				8 344		8 280			4 201 26

THE VALKYR COMPANY									
Sheet 11									
At NEW YORK Store.									
INVENTORY of TOMAH Tannage									
On hand December 31, 1923									
SIDES	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE \$	AMOUNT	
		Common Hide.							
202		#1/Middleweight	3	660	3	587	24	860	88
4 830		#1/Lightweight	66	168	64	845	23 ~	14	914 35
5 194		#2/Middleweight	90	375	88	567	22 ~	19	484 74
2 974		#2/Lightweight	40	412	39	604	21 ~	8	316 84
<u>BENDS</u>									
178		#1/Lightweight	1	300	1	274	34	433	16
89		#2/Middleweight		777		761	30	228	30
160		#2/Lightweight	1	160	1	137	27 ~	306	99
<u>CROPS</u>									
32		#2/Middleweight		415		407	26	105	82
936		#2/Lightweight	9	452	9	263	24 ~	2	223 12
14 595			213	719	209	445		46	874 20

THE VALKYR COMPANY

Sheet 12

At NEW YORK Store.INVENTORY of TOMAH TannageOn hand December 31, 192 3

SIDES	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE ¢	AMOUNT		
		<u>Buenos Aires</u>								
3 884		#1/Middle Run	71	140	69	717	24	16	732	08
6 517		#2/Middle Run	118	562	116	191	22	25	562	02
69		#2/Middle (water dgd)	1	112	1	090	16		174	40
<u>CROPS</u>										
411		#2/Middle Run	5	518	5	408	26	1	406	08
1 360		#3/Middle Run	22	694	22	240	21	4	670	40
1 700		#1&#2 Light Run	16	894	16	556	22	3	642	32
<u>BENDS</u>										
25		#2/Overweight Run		269		264	30		79	20
9 581		#2/Middleweight	87	294	85	548	30	25	664	40
35		#2/Middleweight (water dgd)		290		284	16		45	44
3 798		#1&#2 Lights	26	633	26	100	26	6	786	00
<u>OFFAL.</u>										
		Overweight Shldre	4	696	4	673	13		607	49
		Middleweight "	3	085	3	070	13		399	10
		Heads		40		40	08		3	20
27 380			358	227	351	181		85	772	13

THE VALKYR COMPANY									
Sheet 13									
At NEW YORK Store.									
INVENTORY of LISTLE Tannage									
On hand December 31, 1923									
SIDES	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE ¢	AMOUNT	
63		Run	1	274	1	261	28	353	08
<u>BACKS</u>									
1 462		Flp Run	27	352	27	078	40	10 831	20
3 660		Md Run	57	432	56	858	40	22 743	20
233		Lt Run	2	938	2	909	40	1 163	60
5		Bulls		108		107	34	36	38
4		Scabs		50		49	18	8	82
<u>BENDS</u>									
41		#1		507		502	50	251	00
60		#2		754		746	50	373	00
48		#3		605		599	50	299	50
		Ty Bellies	160	596	159	793	16	25 566	88
		Dgd Bellies	2	379	2	367	13	307	71
		Heads	21	630	21	522	10	2 152	20
		Shoulders		624		621	22	136	62
5 576			276	249	274	412		64 223	19

THE VALKYR COMPANY

Sheet 14

At NEW YORK Store.INVENTORY of WONEWAC Tannage

On hand December 31, 1923

BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.	CHARGED WEIGHT - LBS.	PRICE ¢	AMOUNT		
1 000		#2 14/17 Run	14 990	14 840	42	"	6 232	80
1 000		#3 14/17 Run	15 122	14 971	38	"	5 688	98
4 071		Run	51 406	50 892	42	"	21 374	64
12		Scabs	117	116	18		20	88
		<u>OFFAL.</u>						
		Heavy Bellies	11 623	11 565	19	"	2 197	35
		Light Bellies	67 807	67 468	17	"	11 469	56
		Heads	163 331	162 514	10	"	16 251	40
		Rough Shlds	264	263	18		47	34
		In Transit						
2 000			30 578	30 276		"	12 712	72
8 083			355 238	352 905			75 995	67

THE VALKYR COMPANY									
Sheet 15									
At NEW YORK Store									
INVENTORY of WONEWAC Tannage									
On hand December 31, 1923									
BACKS	BDLS.	SELECTIONS	GROSS WEIGHT - LBS.		CHARGED WEIGHT - LBS.		PRICE	AMOUNT	
37 474		Run	513	512	508	377	39	198	287 03
6		Middle Run Backs		91		90	39		35 10
36		Scabs Backs		418		414	18		74 52
1		#4 Backs		11		11	15		1 65
32		Dark Run Backs		484		479	34		162 86
<u>SIDES</u>									
2 818		Run New	58	936	58	347	30	17	504 10
2 637		Run Old	39	752	39	354	27	10	625 58
<u>DROPS</u>									
5 262		Run	89	482	88	587	41	36	320 67
12		Bull		302		299	26		77 74
<u>OFFAL</u>									
		Tannery Bellies	101	061	100	556	19	19	105 64
		Shoulders		589		586	22		128 92
48 278			804	638	797	100		282	303 81

Clerical Accuracy

When the senior assistant in charge of the audit received the above inventory sheets from the assistant treasurer of The Valkyr Company, he immediately assigned a junior assistant to test the extensions and to verify the footings of these sheets. After discussing the matter with the senior in charge of the audit, the junior verified all extensions of \$5,000 and over, while the smaller items were carefully scrutinized and many of them tested. The footings were verified from the dollar column. Any errors found were to be listed on a separate schedule, and so included in the auditor's working papers; if errors of significance were discovered the company's accounts would have to be adjusted accordingly. As shown by the tick-marks on the above inventory sheets, numerous items were tested by the author; the inventory was found to have been carefully and accurately prepared. (See auditor's Schedule A⁶, page 195.)

Upon the completion of this work a summary of the inventory was prepared. This classified the various tannages under the various kinds of leather, such as sides, backs, bends, crops, and sundries. A physical inventory was taken by the company during the course of the audit and worked back to December 31, 1923 by adding back all sales made since the close of the period and deducting all purchases received during that period.² These computations were made in terms of quantities rather than in terms of dollars, the amounts being later computed by applying relative prices to the increases or decreases in quantity. Since the physical inventory was slightly in excess of the book inventory, and since it was believed that the book inventory was so accurately kept that it was more reliable, and was therefore preferable to any physical inventory which was apt to be taken, no change was made in the accounts for purposes of the audit. Through this summary (see the auditor's A² schedules) it was ascertained that the totals of the sheets submitted to the auditor supported and were in agreement with the inventory as shown by that account in the general ledger. This completed the verification work regarding the clerical accuracy of the inventory.

² See Montgomery *Auditing Theory and Practice*, 4th rev. ed., p. 152, ¶21; Bell, *Auditing*, pp. 152-157; Eggleston, *Auditing Procedure*, p. 124; Kohler and Pettingill, *Principles of Auditing*, pp. 76-77; Jackson, *Audit Working Papers*, pp. 74-75, 80-81, 84; *Journal of Accountancy*, Vol. XVIII (November, 1914), pp. 337, 341.

The Physical Quantities

As regards the physical quantities of leather on hand, a letter was obtained from the manager of the New York sales branch of The Valkyr Company, stating that the inventories were to the best of his knowledge correct and accurately computed. It was also stated in this certificate that all obsolete or inactive stocks had been segregated from the regular stock and had been conservatively priced at estimated realizable values. Similarly, any stocks which were on hand in the company's warehouses not belonging to the company were omitted from the inventory.

The auditor next obtained the perpetual inventory cards kept by the New York Sales Branch and compared these in detail with the summary lists presented for auditing purposes, or with the list from which the summary was prepared. In the latter case the secondary lists were also proved to be correct, and were checked to the sheets in the auditor's possession. The auditor also picked out certain items at random, and inspected the quantities for these in the warehouse; after making allowance for purchases and sales following the close of the period, the quantities examined were found to be approximately in agreement with the book records.

Valuing the Inventory

The remaining task, and perhaps the most important one with reference to this inventory, was the verification of the prices at which the inventory was carried in the accounts. Since, as stated previously, no manufacturing costs were obtained for the various grades of leather tanned, the prices on all items were based upon realizable values at December 31. These prices were prepared by the Chicago office of The Valkyr Company and were furnished to the New York sales branch for the purpose of computing the value of the inventory in stock there (see auditor's A³ schedules, pages 188-195). In verifying the inventory prices all items amounting to \$5,000 or more were checked to the list of inventory prices furnished from Chicago. Tests were made of a considerable proportion of the items of less than \$5,000. All prices used by the New York sales branch were found to be in agreement with those furnished by the Chicago office.

Because of the very critical condition of the leather market at December 31, 1923, it was thought wise by Messrs. Cartwell, Kittredge & Co. to examine still further into the prices used by The Valkyr Company. Consequently, a letter was written by the Chicago office of the auditing firm to its New York office directing the auditor in charge of the work to use the greatest care in checking the inventory prices. This letter (see the auditor's working papers, Schedule A⁴) instructed the accountant in charge of the audit to make a comparison "between prices on all items of \$10,000 or over and actual sales made in November and December, 1923, and January, 1924." The assistant therefore prepared a list of all items in the inventory of \$10,000 and over. Prices of actual sales, as shown by the carbon sales invoices and by the sales book, were checked to this list. In fact, the sales were so few in number that all sales of \$5,000 and over were checked, while thorough tests were made of sales between \$2,000 and \$5,000 (see the auditor's A⁵ working schedules).

This comparison of sales prices and inventory prices showed that selling prices during the three months taken were approximately identical with the inventory prices used as of December 31, 1923. This made no allowance for the 4% sales discount allowed customers, nor for the general selling and administrative expenses of the business. This study assisted greatly in explaining the very large losses suffered by The Valkyr Company for the year ended December 31, 1923.

In addition to the above, the auditor made such general tests and examinations and asked such questions as he believed the circumstances of the case required. The assistants examined both the shipping and receiving records for a few days prior to and following December 31 in order to satisfy themselves that the goods actually included in the inventory were on hand or were in transit and should be included as inventory of The Valkyr Company. Similarly, it was ascertained that no sales of goods to foreign countries had taken place in recent months, and therefore that no possible loss could have been suffered by the company because of a drop in exchange rates.

The complete working papers of Messrs. Cartwell, Kittredge & Co., auditors for The Valkyr Company, follow :

THE VALKYR COMPANY

A

New York Sales Branch

SUMMARY OF INVENTORIES - DECEMBER 31, 1923

Balance, per General Ledger . . .			<u>A^{2a}</u>	\$2,905,986.08
				<u>To B/S</u>
Summary by Tanneries:*				
Hazelhurst - Sheet No. 1 . . .	\$257,927.00			
" 2 . . .	309,280.75			
" 3 . . .	207,736.90	\$ 774,944.65		
Mapleton - " 4 . . .	380,777.94			
" 5 . . .	456,566.44			
" 6 . . .	320,501.69	1,157,846.07		
Shelocta - " 7 . . .	300,919.39			
" 8 . . .	91,970.81			
" 9 . . .	4,201.26	397,091.46		
Riblake - " 10 . . .	20,934.90	20,934.90		
Tomah - " 11 . . .	46,874.20			
" 12 . . .	85,772.13	132,646.33		
Listle - " 13 . . .	64,223.19	64,223.19		
Wonewac - " 14 . . .	75,995.67			
" 15 . . .	282,303.81	358,299.48		
		<u>\$2,905,986.08</u>	<u>J</u>	

* For summary by kinds of leather, see Schedules A² and A^{2a}.

THE VALKYR COMPANY
New York Sales Branch
New York

: A¹

February 10, 1924

Messrs. Cartwell, Kittredge & Co.,
120 Broadway,
New York, N. Y.

Gentlemen:

CERTIFICATE OF INVENTORIES

I hereby certify that the inventories of The Valkyr Company located at the Selling Department, New York, at December 31, 1923, and valued at \$2,905,986.08, were ascertained as follows:

(1) The quantities were obtained from our book inventories which are maintained as perpetual inventories, verified—and to the best of my knowledge are correct.

(2) All obsolete, slow-moving, or inactive stocks, so far as could be determined, were duly segregated from active stocks and have been conservatively priced at estimated realizable values.

(3) Any stocks in company warehouses not the property of the company were excluded from the inventories. Also all liabilities for stock received or taken into the inventory were taken up in the books as of the above date, as were also all other liabilities of the company.

(4) All inventories were priced at estimated realizable values at December 31, 1923, as furnished by the Chicago office of The Valkyr Company.

Yours very truly,

THE VALKYR COMPANY

(Signed) L. Wesley Gall
Manager

THE VALKYR COMPANY—NEW YORK SALES BRANCH
INVENTORY SUMMARY — DECEMBER 31, 1923

A²

TANNAGE	BOOK INVENTORY				PHYSICAL INVENTORY (Leather in Stores)				VARIATIONS			
	Pieces	Weight lbs.	Amount		Pieces	Weight lbs.	Amount		Pieces	Weight lbs.	Amount	
SIDES:												
Hazelhurst	7	42	\$ 4.20		8	43	\$ 4.30		1	1	\$.10	
Mapleton					1	6	1.26		1	6	1.26	
Shelcta												
Ribiaka												
Tomah	23,670	383,601	86,045.31		23,681	384,532	86,519.70		11	931	474.39	
Listle	63	1,261	353.08		62	1,263	353.64		2	2	56	
Wonevac	5,455	97,701	28,129.68		5,451	97,790	28,070.15		4	89		\$ 59.53
Totals	29,195	482,605	\$ 114,532.27		29,203	483,634	\$ 114,949.05		13	1,029	\$ 476.31	\$ 59.53
BACKS:												
Hazelhurst	166,285	2,296,143	\$ 745,051.53		165,998	2,291,875	\$ 744,858.37					
Mapleton	235,236	3,221,399	1,141,560.17		235,771	3,229,651	1,144,365.85		535	8,252	\$ 2,805.68	\$ 193.16
Shelcta	66,114	1,000,481	370,703.51		67,019	1,014,369	375,699.19		905	13,888	4,995.68	
Ribiaka					10	193	64.39		10	193	64.39	
Tomah	5,364	87,001	34,783.20		5,362	87,078	34,812.46			77	29.46	
Listle	45,632	620,466	244,571.18		46,981	642,394	252,684.54		1,349	21,928	8,113.36	
Wonevac												
Totals	518,631	7,225,490	\$2,536,669.59		521,141	7,265,560	\$2,552,484.80		2,799	44,338	\$ 16,008.37	\$ 193.16
BENDS:												
Hazelhurst	126	1,148	\$ 462.54		128	1,213	\$ 489.26					
Mapleton	45	634	285.30		46	628	282.60		2	65	\$ 26.72	
Shelcta	1	15	6.90		2	24	10.59		1	9	3.69	\$ 2.70
Ribiaka	19,682	99,690	20,934.90		19,691	100,173	21,132.93		9	483	198.03	
Tomah	13,866	115,368	33,543.49		13,886	115,745	33,656.59		20	377	113.10	
Listle	149	1,847	923.50		160	1,938	969.00		11	91	45.50	
Wonevac												
Totals	33,869	218,702	\$ 56,156.63		33,913	219,721	\$ 56,540.97		44	1,025	\$ 387.04	\$ 2.70

THE VALKYR COMPANY—NEW YORK SALES BRANCH
INVENTORY SUMMARY - DECEMBER 31, 1923 (Cont'd)

A, 2,

THE VALKYR COMPANY

Chicago, Illinois

A^{3a}INVENTORY PRICES - DECEMBER 31, 1924²

THE VALKYR COMPANY - NEW YORK SALES BRANCH

Description	Sides	Crops	Backs	Bends	Offal
HAZELHURST:					
Country Hide (Old)					
Damaged			26		
Dark Run			26		
Country Hide (New)					
Middle Run			36		
Light		32	34		
Damaged		32	30		
Scabs		27	18		
Strips		30			
Pieces			10		
Dark Run			30		
Chicks			30		
Bulls		32			
Russett Harness		32	34		
Scotia #1				45	
Badger #1				43	
Cuban Country					
Middle Run			32		
Light			30		
Damaged			25		
Bulls			30		
Damaged Bulls			25		
Saladero Ox Hide					
Plump Run			33		
Middle			33		
Bulls			32		
Packer Steer					
Plump Run			40		
Middle			39		
Light			36		
Damaged			33		
Bulls			32		
Scabs			18		
Pieces			10		
Rio Grande & Campiano					
Plump Run			38		
Middle			36		
Light			32		
Damaged			31		
Bulls			32		
Scabs			18		

² In terms of cents per pound.

THE VALKYR COMPANY

A^{3b}

Chicago, Illinois

INVENTORY PRICES - DECEMBER 31, 1924

THE VALKYR COMPANY - NEW YORK SALES BRANCH

Description	Sides	Crops	Backs	Bends	Offal
HAZELHURST (Cont'd):					
Country					
Middle Run			32		
Light			30		
Damaged			25		
Bulls			30	38	
Scabs			18		
Run			30		
Pieces	10		10		
Damaged Bulls			27		
Plump Run				38	
Tannery Bellies					13
Store Shoulders					20
Bull Bellies					13
Head Pieces					10
MAPLETON:					
Packer Steer					
Plump Run			40		
Middle			39		
Light			36		
Damaged			33		
Bulls			32		
Scabs			18		
Dark Run			30		
Pieces			10		
Tannery Damaged Run			33		
Shoulders					24
Heads					10
Bellies					16
Damaged Bellies					13
Rio Grande Hide					
Plump Run			38		
Middle			36		
Light			32		
Damaged			31		
Bulls			32		
Scabs			18		
Shoulders					19
Havana Packer					
Run			30		
Store					
Run			45		
Bellies					16
Bull Bellies					13
Heads					10
Country					
Middle Run			32		
Light Run			30		
Bull			30		

THE VALKYR COMPANY

A^{3c}

Chicago, Illinois

Inventory Prices - December 31, 1923

THE VALKYR COMPANY - NEW YORK SALES BRANCH

Description	Sides	Crops	Backs	Bends	Offal
<u>MAPLETON (Cont'd):</u>					
Bahia					
Light Run			26		
Damaged Run			26		
Bull			23		
Damaged Bulls			20		
Scabs			18		
City Butcher's Matadero Cows & Finnigan					
Middle Run			31		
Light Run			32		
Damaged Run			28		
Bulls			32		
Scabs			18		
Dark Run			28		
Run			32		
Old Packer Cow					
Light Run			30		
Dark Run			26		
Branded Cow New					
Middle Run			36		
Light Run			34		
Damaged Run			30		
Bulls			32		
Scabs			18		
Branded Cow					
Middle Run			36		
Light Run			34		
Damaged Run			30		
Scabs			18		
<u>SHELOCTA:</u>					
Packer Steer					
Plump Run			40		
Middle Run			39		
Light Run			36		
Damaged Run			33		
Bulls			32		
Scabs			18		
Tannery Damaged Run			30		
Special Light Run			36		
Camp Ox					
Middle Run			35		
Bull				46	
Shoulders					24
Bellies					16
Heads					13

THE VALKYR COMPANY

A^{3d}

Chicago, Illinois

Inventory Prices - December 31, 1923

THE VALKYR COMPANY - NEW YORK SALES BRANCH

Description	Sides	Crops	Backs	Bends	Offal
<u>SHELOCTA (Cont'd):</u>					
Branded Cow					
Middle Run			36		
Light Run			34		
Damaged Run			30		
Scabs			18		
Wet			30		
Chicks			30		
Natural Cow					
Middle Run			37		
Light Run			35		
Damaged Run			30		
Bulls			32		
Scabs			18		
Chicks			30		
Wet			30		
Shoulders					23
Bellies					16
Damaged Bellies					12
Offal					
Taps Pieces					29
X Middleweight Strips					72
Ever Dry Strips					56
A Strips					57
B Strips					35
Butt Branded Strips					35
Branded Strips					35
Branded Light Strips					30
Branded Shoulder Strips					30
Butt Pieces					30
#1 Strips					67
Clear Bend Pieces					65
Branded Bend Pieces					40
<u>RIBLAKE:</u>					
Buffalo					
Tannery Run				21	
Light Run				21	
#1 and #2 Light				21	
Chickens				21	
#1/Light				21	
#2/Light				21	
<u>TOMAH:</u>					
Common Hide					
#1/Middleweight	24				
#1/Lightweight	23			34	
#2/Middleweight	22	26		30	
#2/Lightweight	21	24		27	

THE VALKYR COMPANY

A^{3e}

Chicago, Illinois

Inventory Prices - December 31, 1923

THE VALKYR COMPANY - NEW YORK SALES BRANCH

Description	Sides	Crops	Backs	Bends	Offal
TOMAH (Cont'd):					
Buenos Aires					
#2 Overweight Run				30	
#1 Middle Run	24				
#2 Middle Run	22	26		30	
#2 Middle (Water Damaged)	16			16	
#3 Middle Run		21			
#1 and #2 Light Run		22		26	
Offal					
Overweight Shoulders					13
Middleweight Shoulders					13
Heads					08
LISLE:					
Run	28				
Plump Run			40		
Middle Run			40		
Light Run			40		
Bulls			34		
Scabs			18		
#1				50	
#2				50	
#3				50	
Tannery Bellies					16
Damaged Bellies					13
Heads					10
Shoulders					22
WONEWAC:					
#2 14/17 Run			42		
#3 14/17 Run			38		
Run			42		
Scabs			18		
Offal					
Heavy Bellies					19
Light Bellies					17
Heads					10
Rough Shoulders					18
Backs in Transit			42		
Run		41	39		
Middle Run			39		
Scabs			18		
#4			15		
Dark Run			34		
Run New	30				
Run Old	27				
Bull		26			
Offal					
Tannery Bellies					19
Shoulders					22

CARTWELL, KITTREDGE & Co.

A⁴

Accountants and Auditors

Illinois-Merchants Bank Building

CHICAGO

February 3, 1924

Messrs. Cartwell, Kittredge & Co.
New York

Gentlemen :

THE VALKYR COMPANY

In checking the inventory prices of leather in stores at December 31, 1923, we suggest that in addition to comparing these prices with the schedule of prices sent the company by its Chicago office, that a comparison be made between prices on all items of \$10,000 or over and actual sales made in November and December, 1923, and January, 1924. Owing to the numerous classifications of leather and the abbreviations used in the selling records, we find here that much time is saved in checking by arranging for an employee of the company familiar with these records to work with our assistant doing this work.

For your information, a sale has just been made in Chicago of practically all of the Hazelhurst leather in stores at a price of 28 cents f.o.b. stores for backs, all weights. We mention this because Hazelhurst has been very slow moving for over a year. You had some 165,000 pieces in stock at December 31 priced, we understand, at 26 to 36 cents.

In view of the market position of leather, we are giving special attention to inventories in this audit.

Yours very truly,
CARTWELL, KITTREDGE & Co.
J.B.C.

THE VALKYR COMPANY
New York Sales Branch

A^{5a}

TEST OF SALES OF LEATHER FROM INVENTORY ITEMS OF \$5,000
AND OVER, DURING NOVEMBER, DECEMBER, AND JANUARY

Description	Amount of Inventory		Sales Prices - ¢ per lb. (All sales under \$2,000 ignored) (Sales subject to 4% discount)											
	Per lb.	Amount	Nov. 1923			Dec. 1923			Jan. 1924					
HAZELHURST:														
Country Hide														
Mid. Run	36¢	\$111,902.04				37	36	37	37	37	37	38	37	
Lt. Run	34¢	64,740.76	35	34	35		34	35	35		35	35	35	
Dgd. Run	30¢	48,543.30		31	31		31	31	30		30	32	30	
Crops - Run	32¢	12,436.16						32						
Cuban Country Hide														
Mid. Run	32¢	18,922.56	32	32	33	32		33						
Light Run	30¢	39,259.50			30	30	31	31	31	32	30			
Dgd. Run	25¢	12,696.00					26	26	25	25	25	25	26	
Packer Steer Hide														
Plump Run	40¢	25,077.60				41	41	40	40	41	41	41		
Lt. Run	36¢	30,878.64						37	37	36	36	36	36	
Dgd. Run	33¢	17,524.32	33	34	33		33	33	34	34	33			
Rio Grande & Campiano														
Ox Hide														
Plump Run	38¢	19,655.12			38		38	39	38		39	39		
Mid. Run	36¢	72,269.28												
Lt. Run	32¢	13,760.96		32	32			33	33	32		32	33	
Dgd. Run	31¢	12,728.91					31	32	30		31	32	32	32
Bulls	32¢	12,102.08					33	32	33	33	33	33	34	33
Country														
Mid. Run	32¢	14,515.84		32	33			33	32		33	33		
Lt. Run	30¢	64,480.50			31		30	30						
Damaged Run	25¢	20,287.25					26	26	25	25		26	27	
Bulls	30¢	92,253.30												
MAPLETON:														
Packer Steer Hide														
Mid. Run	39¢	212,182.62												
Lt. Run	36¢	41,258.88											37	
Damaged Run	33¢	20,249.79		34	33	34		33	33	34	34	34		
Rio Grande Hide														
Plump Run	38¢	28,865.56		38	39			39	38	39		38	39	39
Mid. Run	36¢	30,405.96					37	37	36	36	37	37	38	
Light Run	32¢	11,112.96	33	33	32	33		34	33	33				
Damaged Run	31¢	13,537.08					31	31	31		32	32	31	
City But. Mat. & Finn.														
Mid. Run	34¢	18,620.10		34	35			35	34	35	35	35	34	
Lt. Run	32¢	21,078.72	32	32	34		33	32	32	32		32		
Damaged Run	28¢	13,326.60			29			29	28	29		28	28	29
Branded Cow														
Mid. Run	36¢	\$ 56,308.68		36	37		36	37	36	36		37	37	36
Lt. Run	34¢	270,143.94												
Dgd. Run	30¢	42,500.10	31	31	30			31	30	31		32	31	
Mid. Run	36¢	23,926.68			38		37	37	37		36	37		
Lt. Run	34¢	42,090.30		34	35			34	34	35		34	34	
Dgd. Run	30¢	15,070.20	30	30	30			31	32	31		31	31	30
Packer Steer														
Plump Run	40¢	103,967.60												
Mid. Run	39¢	98,931.69												
Lt. Run	36¢	15,233.04	36	36	37			37	36	38	36			
Dgd. Run	33¢	15,630.78			33			33	34	34		33	34	33 31

THE VALKYR COMPANY

A^{5b}

New York Sales Branch

TEST OF SALES OF LEATHER FROM INVENTORY ITEMS OF \$5,000
AND OVER, DURING NOVEMBER, DECEMBER AND JANUARY (Cont'd)

Description	Amount of Inventory		Sales Prices - ¢ per lb. (All sales under \$2,000 ignored) (Sales subject to 4% discount)				
	Per lb.	Amount	Nov. 1923		Dec. 1923		Jan. 1924
RIBLAKE:							
Buffalo - #1 & #2 Lt. . .	21¢	\$17,647.56	22	21	21	22	21
SHELOCTA:							
Packer Steer							
Plump Run	40¢	155,426.00					
Mid. Run	39¢	61,193.73			39		
Lt. Run	36¢	32,848.56	36	36	37	37	36
Dgd. Run	33¢	36,153.48					34
Branded Cow							
Lt. Run	34¢	16,381.20	34		35	35	36
Nat. Cow							
Lt. Run	35¢	33,708.15	35	35	36	36	37
Bellies	16¢	15,294.56			16	16	36
TOMAH:							
Common Hide							
#1 Lt. Wgt.	23¢	14,914.35	23	23	24	24	23
#2 Mid. Wgt.	22¢	19,484.74		22	24	23	22
Buenos Aires							
#1 Mid. Run	24¢	16,732.08	25	24	24	25	25
#2 Mid. Run	22¢	25,562.02		23	23	22	22
Bends #2 Mid. Wt. . .	30¢	25,664.40	30	31	30	32	31
LISTLE:							
Backs - Plump Run	40¢	10,831.20		40	41	41	40
Backs - Mid. Run . .	40¢	22,743.20		40		41	41
Ty. Bellies - Bends	16¢	25,566.88			17	16	17
WONEWAC:							
Backs - Run	42¢	21,374.64		43	43	43	44
Lt. Bellies	17¢	11,469.56	17	17	18	18	17
Heads	10¢	16,251.40			10	11	10
Backs - Run	39¢	198,267.03					
Sides - Run New . . .	30¢	17,504.10	30	31	31	32	31
Sides - Run Old . . .	27¢	10,625.58		27	28	27	27
Crops - Run	41¢	36,320.67			41	42	41
Ty. Bellies	19¢	19,105.64		19	20	20	19
Backs in Transit . . .	42¢	12,712.72					

THE VALKYR COMPANY

A⁶

New York Sales Branch

ERRORS IN INVENTORY—EXTENSIONS 12/31/1924

Inventory Sheet No.	Item	Amount per Inventory Sheets	Correct Amount	Add to (+) or Deduct from (-) Inventory Figure
	No errors found.			

THE VALKYR COMPANY

A⁷

New York Sales Branch

NOTES ON INVENTORY—DECEMBER 31, 1923

(1) Extensions were verified on all amounts of \$5,000 and over. Smaller items were carefully scrutinized, and numerous items tested.

(2) Footings were verified from the dollar column.

(3) Prices on all items in the inventory of \$5,000 and over were checked to the list of inventory prices furnished by the Chicago office. Tests were also made of many items of less than \$5,000. All prices used were in agreement with those furnished by Chicago office.

(4) A list of all items in the inventory of \$10,000 and over was drawn off. Prices of actual sales as shown by the sales book were checked to this list. The three months of November and December, 1923, and January, 1924, were completely covered, all sales of less than \$2,000 being ignored. All sales of \$5,000 or over were checked to the list; thorough tests were made of the sales between \$2,000 and \$5,000. See (6) below.
"Junior"

(5) It was ascertained by questioning that no sales of goods to foreign countries had taken place recently. The accounts with foreign dealers were examined by *"Senior"* and it was found that no sales had been made since July, 1921. Hence no loss on the inventory because of the exchange rate was possible up to February 10, 1924.

(6) From the comparison of sales prices and inventory prices two facts are quite significant:

(a) The proximity of selling prices to the inventory prices—making no allowance for the 4% sales discount, to say nothing of selling and other expenses, etc.

(b) The fact that certain tannages are moving very slowly or not at all. Some of these aggregate quite large amounts—we have checked several items ranging from \$100,000 to nearly a quarter million dollars in which no sales as large as \$2,000 took place during the three months under consideration.

The real question is whether or not the inventory can be liquidated at present inventory values.

"Senior"

Criticize constructively the accounting methods of The Valkyr Company, in so far as they relate to the leather inventory, and determine whether or not the verification made by the auditing

firm was satisfactory for the purposes of a limited-test audit.³ What changes, if any, would you suggest in the verification methods adopted, or in the manner in which the assistants on the audit recorded the results of their work?

PROBLEM 32

CRIMSON, YARDLEY & CO., INC.

Audit of Retail Inventory

Crimson, Yardley & Co., Inc. conducted a department store in Pasadena, California. There were eighteen departments in the store. The merchandise stock was priced at retail only, the "retail inventory method" of accounting being used.¹ By the use of the retail inventory method the inventory for balance sheet purposes was priced at approximate cost, that is, at the price for which it was anticipated the goods would sell, less the "mark-up," or expected gross profit, that obtained for that class of merchandise. The amount of this mark-up was determined from the accounting records.

Among the accounting records of Crimson, Yardley & Co., Inc. was a vouchers payable book for merchandise purchases; this was called the merchandise register. A separate page of this book was devoted each month to each department; this register is shown as Figure 1, page 198.

³ See *Journal of Accountancy*, Vol. XXIII (January, 1917), pp. 27-32; National Association of Cost Accountants Yearbook, 1921, pp. 167-175; *Journal of Accountancy*, Vol. XLVII (January, 1929), pp. 20-36.

¹ See McNair, *The Retail Method of Inventory*, entire; *A Standard Method of Accounting for Retail Stores*, Official Publication of the Controllers' Congress, National Retail Dry Goods Association, Vol. I, p. 20; David and McNair, *Problems in Retailing*, pp. 260-261.

A brief description is quoted from the last reference above, viz.: "For each department, or for each section or separate classification of merchandise, inventory at the beginning of a period was entered at both cost and retail figures, and all purchases made during the period were entered likewise at both cost and retail prices, the total retail figure being adjusted to include additional mark-ups, less additional mark-up cancellations. Thus, total cost figures and total retail figures were available for all merchandise handled during the period. The difference between these total cost and retail figures was the amount of mark-up, which was computed as a percentage of the total retail figure. From the total retail figure was subtracted the net sales figure for the period plus mark-downs (and downward price changes for any other reasons) less mark-down cancellations; the remainder was a book figure for the retail value of merchandise in stock. Any discrepancy between the retail book inventory figure and the physical inventory figure was a retail stock shortage, or overage, as the case might be. To the physical retail inventory figure was applied the complement of the percentage of mark-up in order to ascertain the cost-or-market valuation of the closing inventory." From the case, The Baskerville Company.

³(Continued)[illegible]

GROSS PROFIT RECORD										DEPARTMENT _____		192 _____
PERIOD	PURCHASES			INVENTORY DEDUCTIONS			INVENTORY		COST OF Sales	GROSS PROFIT		
	Retail	Cost	Mark-up	%	Mark-downs	Shrinkage	Sales	Retail		Cost	Amount	%
INVENTORY (OPENING)												
January Accumulative												
February Accumulative												
March Accumulative												
April Accumulative												
May Accumulative												
June Accumulative												

Figure 2

At the close of the fiscal year, December 31, 1928, Crimson, Yardley & Co., Inc. took a physical inventory of all merchandise on hand; this was used in the closing of the books and in the preparation of the company's financial statements. The inventory was valued at retail prices, and then reduced to approximate cost by applying the complement of the percentage mark-up to the retail value. The physical inventory was prepared by having one individual count the articles in the various departments, and by having them listed on sheets by a second individual; upon the completion of the count the sheets were signed by both the person who made the count and the one who listed the articles. Retail prices to be used in valuing the inventory were entered, along with the description and letter,⁴ by the persons making the count; these prices were then approved by the general manager before any computations were made. Later the sheets were extended and footed by two office employees; the first employee carried the extensions into the last column, footed it, and tore off the strip along the perforation. The second employee then made extensions into the column that was now last, and footed it. The summary sheet for each department, and for the store as a whole, was prepared in a similar manner. The two sets of totals were agreed for all sheets and departments.

All of the above information was available when, in late January, 1929, Messrs. Knowles & Knowles, Certified Public Accountants, 530 West Sixth Street, Los Angeles, took up the annual audit of the company's accounts. The audit, as in prior years, was to be a limited-test audit; a certified balance sheet and a report were to be submitted as a result of the audit.

With reference to the verification of the inventory the auditors were furnished with the original inventory sheets, which had been prepared as above described.⁵ These sheets were carefully scrutinized, tests were made of the extensions, and the footings were proved as shown by the audit tick-marks (✓) on the inven-

⁴ The letter indicated the approximate age of the article, the letters being assigned at the time the goods were received and priced. The letter was changed each six months; for example, "O" indicated that the goods were received between January 1 and June 30, 1928, "P" between July 1 and December 31, 1928, and "Q" after January 1, 1929.

⁵ The summary inventory sheet, and page 1 of the detailed inventory with the perforated right-hand edge attached, are included for Department IV; all departmental inventories were prepared in the same manner. The sheets referred to are shown on pages 202 and 203.

tory sheets for Department IV.⁶ The auditor then prepared adding-machine tapes of the page footings for each department; these tapes were preserved in the working papers.

Upon satisfying themselves as to the clerical correctness of the inventory sheets, the auditors next gave their attention to the accuracy of the physical quantities and the reasonableness of the prices used. Tests were made of physical quantities by choosing at random certain items from the inventory, and agreeing these (taking into account purchases and sales since the close of the

⁵ (Continued)

CRIMSON, YARDLEY & CO., INC.					
Date <u>December 31, 1928</u>		Inventory Department <u>4</u>		Summary Page <u> </u>	
Quantity	Unit	Item	Retail	Extended Retail	Extended Retail
		Page 1		\$ 3,104.50~	\$ 3,104.50
		2		2,672.75~	2,672.75
		3		1,840.50~	1,840.50
		4		989.00~	989.00
		5		4,396.50~	4,396.50
		6		2,952.75~	2,952.75
		7		1,023.25~	1,023.25
		8		2,792.00~	2,792.00
		9		2,970.00~	2,970.00
		10		373.75~	373.75
		11		700.00~	700.00
		12		326.75~	326.75
		13		408.50~	408.50
Total				\$24,550.25	\$24,550.25
Counted		Listed		Priced	
				Extended	
				Added	

⁶ See Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 72-73.

fiscal period) with the quantities actually on the shelves.⁷ No significant discrepancies were discovered. Prices were tested by choosing from the lists items approximating some 40% of the total inventory, and comparing the prices set forth thereon with those on the goods still in stock; as a further test, a considerable number of items were traced to purchase invoices to determine how far the computed cost was from the actual cost. Both tests showed that the goods were valued at approximate cost.

⁵ (Continued)

CRIMSON, YARDLEY & CO., INC.					
Date <u>December 31, 1928</u>		Inventory Department <u>4</u>		Page <u>1</u>	
				Inventory Department <u>4</u> Page <u>1</u>	
Quantity	Unit	Item	Retail	Extended Retail	Extended Retail
1		Rubber coat	P	\$ 7.50	\$ 7.50
2		"	P	16.00	16.00
3		Rain coat	P	18.00	144.00
1		"	P	18.00	18.00
38		"	P	10.00	380.00
3		Red Slickers	P	6.00	18.00
1		" (WTG)	O	6.00	6.00
4		Green "	O	6.00	24.00
4		Suits	O	49.50	198.00
9		"	P	49.50	445.50
2		"	P	45.00	90.00
1		"	O	45.00	45.00
1		"	O	42.50	42.50
3		" (WTG)	P	39.50	118.50
2		"	P	55.00	110.00
1		"	P	65.00	65.00
1		"	O	40.00	40.00
1		Yellow Slicker	O	6.50	6.50
37		"	P	6.50	240.50
3		Jackets	P	12.00	36.00
1		"	P	10.00	10.00
4		"	P	20.00	80.00
1		"	P	25.00	50.00
1		"	P	10.00	10.00
2		Suits	O	49.50	99.00
4		"	O	49.50	198.00
10		"	O	49.50	495.00
1		"	P	49.50	49.50
1		"	O	42.50	42.50
1		"	P	39.50	39.50
Total				\$3,104.50	\$3,104.50
Counted <u>T. Flowers</u>		Listed <u>W. Stone</u>	Priced <u>C. E. Gale</u>	Extended <u>S. Emmons</u>	<u>T. White</u>
				Added <u>S. Emmons</u>	<u>T. White</u>

⁷ During the months immediately preceding the time this manuscript went to press there was a new outbreak of discussion regarding the extent to which the auditor should be

The auditors next turned their attention to a test of the percentage of gross profit. This test cross-sectioned the business of the year in two different ways, (a) the first involving all departments* for the month of October, and (b) the second taking Department VI for all twelve months of the year under audit. During the process of making these tests certain other matters also offered opportunity to verify the accuracy of the client's records. The footings of the merchandise register were checked. Price change summaries were verified with the price change records; the latter were scrutinized to make certain that they were correctly made out and had been properly approved. The footings of the departmental sales record were also proved; in the case of all of these records, the items proved were traced to the gross profit record.

Upon comparing the summary sheets of the physical inventory with the gross profit record it was observed that a considerable discrepancy existed between the book figures and physical inventory figures for Department IV. According to the physical inventory the amount for Department IV was \$24,550.25, whereas according to the record the amount was \$23,240.45; the book inventory was \$1,309.80 under the physical count.⁸ The management had been at a loss to learn why this discrepancy existed; the department head had gone over the inventory sheets carefully, and had recounted all items about which there was any question as to the accuracy of the original count, but he had found no errors.

Because of this situation the auditors used special care in examining the records relating to this department. They discovered a price change ticket, dated September 25, 1928, which provided for an additional mark-up of \$1,460.40; this ticket had been overlooked in the preparation of the summary of price changes for September. Upon inquiry it was learned that the price tags on the goods had been altered; several of these altered tags were shown to the auditors. After discussion with the manager the auditors recommended that the gross profit record be

responsible for physical inventories. See, for example, *The American Accountant*, Vol. 13, No. 11 (November, 1928), pp. 5-9; also *The Journal of Accountancy*, Vol. XLVI, No. 6 (December, 1928), pp. 416-425.

⁸ See footnote 5 on page 201 ff.

changed to include the mark-up. The final percentage of mark-up would be increased from 29.27 to 30.72; the auditors prepared the following tabulation to show the effect this would have upon the inventory of Department IV:⁹

	<u>Mark-up</u> <u>29.27%</u>	<u>Mark-up</u> <u>30.72%</u>	<u>Increase</u>	<u>Decrease</u>
Physical inventory at retail	\$24,550.25	\$24,550.25		
Physical inventory at "cost"	17,364.39	17,008.41		\$355.98
Cost of sales	31,934.70	32,290.68	\$355.98	
Gross profit	12,628.11	12,272.13		355.98

The books of the company had been closed for the fiscal period, and the manager objected to opening them again. It was recognized that future figures would be affected by this omission, but nevertheless the manager decided to neglect it entirely.¹⁰ In their working papers, however, the auditors made the following adjusting journal entry:

Cost of Sales	\$355.98
To Inventory	\$355.98

The tests of the percentages of gross profit in the other departments of the store revealed no error of any consequence. The total of the departmental inventories, at the approximate cost

⁹ The last line of the gross profit record for this department would be altered to read as follows:

	<u>Retail</u>	<u>Cost</u>	<u>Mark-up</u>	<u>%</u>
Per books	\$69,696.85	\$49,299.09	\$20,397.76	29.27
Correction	1,460.40		1,460.40	
Corrected	\$71,157.25	\$49,299.09	\$21,858.16	30.72

¹⁰ While the error in the percentage of mark-up was 1.45 at December 31, 1928, it would constantly become less. Assuming that the volume of purchases would be approximately the same in 1929 as in 1928, the following figures show the effects of making and not making the correction.

Percentage Mark-up Corrected

	<u>Retail</u>	<u>Cost</u>	<u>Mark-up</u>	<u>%</u>
Inventory	\$24,550.25	\$17,008.41	\$ 7,541.84	30.72
Purchases	46,860.00	33,065.00	13,795.00	29.44
	\$71,410.25	\$50,073.41	\$21,336.84	29.88

Percentage Mark-up Not Corrected

	<u>Retail</u>	<u>Cost</u>	<u>Mark-up</u>	<u>%</u>
Inventory	\$24,550.25	\$17,364.39	\$ 7,185.86	29.27
Purchases	46,860.00	33,065.00	13,795.00	29.44
	\$71,410.25	\$50,429.39	\$20,980.86	29.38

The percentage mark-up error, which was 1.45 at December 31, 1928, would be 0.50 at December 31, 1929; in another year of similar volume the error would be practically or entirely eliminated.

figures used, was \$246,539.42; this amount, less the \$355.98, gave a net cost for the merchandise on hand at December 31, 1928, of \$246,183.44.

Entries in the merchandise register and in the receiving records since December 31, 1928 were next scrutinized; all invoices dated in 1928 but entered in the books in 1929 were examined. These showed that a total of \$12,747.53 of goods were in transit at December 31. The receiving records showed that these goods were all received subsequent to the date of the audit with the exception of one shipment amounting to \$95.40 which was received on November 26, but the invoice for which had for some reason been delayed. All of these goods were found to be on hand and to have been included in the physical inventories; adjusting journal entries were accordingly prepared, as follows:

Cost of Sales	\$	95.40	
To Purchases			\$ 95.40
Inventory	12,652.13		
To Purchases			12,652.13
Purchases	12,747.53		
To Accounts Payable			12,747.53

These adjustments brought the physical inventory figures and the book figures into so close agreement that it was decided to make no further changes. This gave an inventory figure for the balance sheet of \$258,835.57.

Upon the completion of the verification work, and as a final precaution, the auditors obtained the following inventory certificate:

CRIMSON, YARDLEY & Co., INC.
Pasadena, California

February 16, 1929.

Messrs. Knowles & Knowles,
530 West Sixth Street,
Los Angeles, California.

Gentlemen:

I hereby certify that the merchandise inventories as of December 31, 1928, amounting to \$258,835.57, were taken under my personal supervision. Where possible the inventories were taken by actual count, weight or measurement, and, where not so possible, by conservative estimate. All

damaged, obsolete, and shop-worn goods were either omitted entirely from the inventory, or were priced at estimated realizable values. The inventories, aside from the above, were valued at retail prices, and then reduced to approximate cost by the application of the percentage of gross mark-up by departments to the retail values. The title to all merchandise is in the company; there is no merchandise on consignment.

Yours very truly,
(Signed) C. E. GALE, Mgr.

Criticize constructively the above audit of inventories. Should the auditors have made further verification of the inventory of Crimson, Yardley & Co., Inc.? If so, what? Was more verification made in any respect than was necessary? If so, what? Discuss.

PROBLEM 33

THE MONTIETH-PACIFIC COMPANY

Certificate of Inventories

The Montieth Company of Philadelphia, manufacturers and distributors of sporting goods (including firearms, ammunition, fishing tackle, etc.), had its accounts audited annually by Messrs. Julius, Caesar & Co. of that city. The Montieth Company also had subsidiary companies organized in various states of the United States, these companies acting as distributing jobbers for the products of the parent company; in addition to the product of The Montieth Company these jobbing houses also carried a certain amount of additional merchandise of a non-competing character, in order to be able to serve most effectively the company's customers (that is, the retailers who handled the company's products). Messrs. Julius, Caesar & Co. also audited, through its various branch and affiliated offices, all of these subsidiary distributing companies; a consolidated balance sheet was prepared annually, and certified by the accounting firm.

The Montieth-Pacific Company, a company organized under the laws of California and with its principal place of business at 245 Mission Street, San Francisco, was a wholly-owned subsidiary of The Montieth Company of Philadelphia. The subsidiary company distributed the Philadelphia company's product

to retail dealers on the Pacific Coast from Alaska on the north to Mexico on the south. The sales of the Pacific Coast branch approximated \$2,000,000 per annum.

In accordance with instructions received, the San Francisco office of Messrs. Julius, Caesar & Co. proceeded to audit the books and accounts of The Montith-Pacific Company for the fiscal year ended April 30, 1928. The only assets of the company of special importance were the accounts receivable and the merchandise inventory. Upon the completion of the inventory verification,¹ the senior assistant in charge of the audit obtained the following inventory certificate from the officials of the Pacific Coast company.

This certificate of inventories was drafted by the senior assistant in charge of the audit, after which it was discussed with the officials of the company; it was then typed by the secretary to the general manager of the company, signed by the officials, and included by the senior assistant in his working papers (which, after being reviewed in the local office, were forwarded by registered, first-class air mail to Messrs. Julius, Caesar & Co., Philadelphia).

San Francisco, California,
May 24, 1928.

Messrs. Julius, Caesar & Co.,
Standard Oil Building,
San Francisco, Calif.

Dear Sirs:

CERTIFICATE OF INVENTORY

We hereby certify that the inventories of merchandise

On hand	\$501,944.70
In transit	72,193.45
Freight addition at 3.88%	20,450.30
Total	<u>\$594,588.45</u>

as of April 30, 1928, were taken under our supervision by actual count; that the inventories included only such items as were actually on hand or in transit, to which the company had legal title, and for which a corresponding liability had been taken up in the books. We also certify that

¹ The inventory verification included a careful survey of the instructions and methods used for taking the physical inventory, a rather complete test of the accuracy of the records of physical quantities, a thorough test of the pricing, and the usual test of the clerical accuracy of the amounts.

at April 30, 1928, no merchandise owned by this company was on consignment with dealers or others.

We further certify that the inventories were priced as follows:

GENERAL MERCHANDISE—Inventoried at cost prices supplied by the Central Purchasing Department at Philadelphia; in the case of certain miscellaneous purchases, the local invoice cost price was used.

MONTIETH MERCHANDISE—New line products are inventoried at prices supplied from the Central Purchasing Department at Philadelphia; in case of merchandise manufactured by outside firms one per cent is added to cover purchasing commission. Guns are priced at Montieth catalog "net jobbing price list," except that in the case of pistols and revolvers the ten per cent federal tax is added; ammunition is priced at the "net jobbing price list," less two and one-half per cent. The catalogs used for this pricing were effective from April 10, 1928.

Close-out stock is carried in the inventory at \$37,672.49, and includes \$13,247.57 of "Montieth" ammunition. These goods are valued as above, except that any obsolete ammunition carried over from the fiscal year ended April 30, 1927, is valued at the "net jobbing price list," less sixty-six and two-thirds per cent.

Yours very truly,

THE MONTIETH-PACIFIC COMPANY

(Signed) George L. Adamson
V.-Pres. & Gen'l Mgr.

(Signed) Accurate Jamison
Ass't Treas. & Chief Acct.

(Signed) John Storeskeeper
Inventory Manager.

Discuss the significance of the above inventory certificate; does it reduce in any way the auditor's responsibility?

PROBLEM 34

THE SPRAGUE REALTY COMPANY

Valuation of Unsold Lots

The Sprague Realty Company, a corporation organized under the statutes of the state of California, purchased undeveloped tracts of land, subdivided them into building lots, put in streets

and other improvements, and sold the lots for high-grade residential property.

Early in 1928 the company purchased a tract of land in San Mateo County, a few miles south of San Francisco, paying therefor \$220,000; of the purchase price \$70,000 was paid in cash, and a mortgage note bearing interest at 7% was given for the remaining \$150,000. During the following few months the tract was subdivided into building lots; improvements consisting of sewers, water mains, streets, etc., were installed at a total additional cost of \$60,000. This latter sum was paid in cash.

The tract was divided into 140 residential lots. Of these lots Nos. 1 to 20, inclusive, were valued at \$3,500 apiece; lots Nos. 21 to 40 were valued at \$3,000 each, Nos. 41 to 60 at \$2,800 each, Nos. 61 to 80 at \$2,600 each, Nos. 81 to 100 at \$2,500 each, Nos. 101 to 120 at \$2,400 each, and Nos. 121 to 140 at \$2,200 each. A 5% commission was allowed by the company to the agents who sold the lots; arrangements had also been made with the party holding the mortgage that as each lot was sold a proportional payment might be made on the mortgage, and thus a clear title given to the lots sold.

During 1928 the following lots were sold at the prices enumerated above: lots Nos. 1 to 10, inclusive; Nos. 21 to 28; Nos. 41 to 55; Nos. 61 to 70; Nos. 81 to 92; Nos. 101 to 108; Nos. 121 to 130; and Nos. 135 to 139.

The close of the company's fiscal year was December 31; accordingly, at December 31, 1928 the company made the usual arrangements with Messrs. Goode, Checkem & Company, Certified Public Accountants, Rusk Building, San Francisco, to audit the books for 1928, prepare adjusting and closing entries for the year, and submit a certified balance sheet and detailed audit report as a result of their work. One of the chief problems which confronted the auditors was to determine the value at which the unsold lots in the above tract should be included in the accounts of the company, and in the balance sheet to be certified.

At what figure should the unsold lots be inventoried? Give reasons for the basis which you have chosen. Outline the verification which you believe the auditors should make with reference to all the above transactions affecting the subdivision.

PROBLEM 35**THE ANTEA COMPANY****Audit of Inventories Not Owned**

The Antea Company has requested you to audit its accounts for the fiscal year ended December 31, 1924. The company purchases crude oil, manufactures it into gasoline and other refined products, and distributes its products within a radius of 300 miles of its refinery—the latter being located near Philadelphia. The trial balance figures for inventories were as follows:

Crude oil	\$600,000.00
Refined products	820,000.00
Materials and supplies	230,000.00

All of the above products and supplies are located at the company's refinery. During the course of your audit, however, you ascertained from various documents and indentures that the title to all crude oil and refined products located at or destined for the Antea refinery is vested in the First National Bank of Philadelphia, Trustee, to secure demand loans, of The Antea Company from the bank, up to 80% of the current market value of the crude or refined oil. The company had title to all materials and supplies on hand in the inventory.

From the same sources you learned that The Antea Company might also act as jobber, buying crude oil at one point and delivering it to some customer without its passing through the refinery or the storage tanks located there. In such cases the title to the oil did not pass to the bank.

You further ascertained that under the supervision of an agent of the bank physical inventories had been taken as of December 31; your audit showed that refined products were valued at cost, and that crude oil, materials and supplies were valued at cost or market, whichever was lower at December 31. You discovered an error in the pricing of certain supplies; this resulted in an overstatement, in the amount of \$10,000, of the value of certain materials and supplies as reflected by the above trial balance figures.

By determining the location and destination as at December 31 of each vessel owned or under charter by The Antea Company you found that \$500,000 of crude oil was in transit; none of this was included in the accounts as listed in the general ledger trial balance. Your examination of the various shipping documents revealed that two cargoes of this oil, having a value of \$260,000 were bound for the Antea refinery; the other two tankers were bound directly for New York City, where their cargoes, obtained from Mexican ports, were delivered to customers of The Antea Company.

Outline the verification that should be made of the above inventories, and show exactly how you would state all inventories in the company's balance sheet prepared for certification.

Part V—Asset Verification (*Concluded*): Fixed Assets and Deferred Charges

PROBLEM 36

ATCHINSON MANUFACTURING COMPANY

Verification of Capital Assets

The Atchinson Manufacturing Company is located in White Plains, New York. The company manufactures small novelty goods, and sells them at wholesale and also through its own retail store. The company has factories in White Plains, in Boston, and in Philadelphia; it also controls the Bancroft Manufacturing Company with a factory in New Haven, Connecticut, and the Cranston Novelty Company with a factory in Cleveland, Ohio. The subsidiary companies maintain their own operating and accounting organizations; they manufacture the products in which the group of companies is interested, buy materials from and sell products to each other and the parent company, besides dealing with outside concerns.

In auditing the group of companies for the year ended August 31, 1927, for the purpose of certifying the consolidated accounts, the auditor began his verification of the property accounts by taking the information shown on page 214 from his previous working papers of August 31, 1926.

An examination of the parent company's books and records revealed the following facts:

(a) The Philadelphia factory was sold during the year under audit for \$125,000. Of the purchase price \$25,000 was paid in cash, and a mortgage was taken for the balance, \$100,000, payable \$10,000 annually, with interest at 6% per annum. The property was acquired in 1918, with periodic additions to certain

SUMMARY OF PROPERTY ACCOUNTS, AUGUST 31, 1926

Items	Atchinson Mfg. Company			Bancroft Mfg. Company	Cranston Novelty Company
	White Plains Factory	Boston Factory	Philadelphia Factory		
Land	\$12,000	\$19,500	\$13,500	\$10,000	\$14,000
Buildings	63,750	86,400	43,600	35,000	47,450
Building Fixtures	21,150	26,320	12,880	9,400	15,320
Machinery and Equipment	87,500	96,800	57,200	41,700	52,670
Dies and Patterns	116,380	78,420	54,600	57,630	71,240
Autos and Trucks	6,200	4,860	5,800	5,460	3,840
Office Furniture	12,800	7,600	6,700	3,840	4,280

items. An examination of the records showed that depreciation had been provided, and arbitrary selling prices assigned, as follows, on the various property items:

Item	Rate	Accrued Depreciation	Arbitrary Selling Price Assigned
Land	None	None	\$13,500
Buildings	2½%	\$13,800	27,500
Building Fixtures	10%	4,320	8,000
Machinery and Equipment	10%	16,480	35,000
Dies and Patterns	17½%	10,760	36,000
Autos and Trucks	20%	980	
Office Furniture	10%	1,310	5,000

The accrued depreciation amounts, obviously, represent the total credits to the reserve for depreciation account less the charges that have been made to the account because of plant units dismantled or sold. The arbitrary selling prices assigned to the various plant units were made by the comptroller merely to simplify the accounting. The autos and trucks were not sold, but were transferred to the White Plains factory.

(b) The Boston factory accounts reflected the following changes during the year:

Land—no change.

Buildings—additions, purchased items, invoice for outside construction, \$8,600. The appropriation, per board of directors' resolution was \$8,500.

Building Fixtures—additions, purchases, \$160, \$285, \$4370, and \$25; transferred from White Plains factory, \$780, and from Bancroft Mfg. Co., \$360. Transferred to White Plains factory, \$180; to Cranston Novelty Co., \$400; fixtures scrapped, cost \$760, depreciation provided, \$490, realized, \$215.

Machinery and Equipment—additions, purchases, \$380, \$260, \$45, \$17, \$265, \$1,720, \$65, \$7, \$95, \$67.50, and \$187.50; transferred from White Plains factory, \$185, \$322.50, \$67.50, \$85, and \$60; transferred from Bancroft Mfg. Co., \$350 and \$60; transferred from Cranston factory, \$110, \$320 and \$85.

Transferred to White Plains factory, \$390, \$420, \$15, \$28, \$42, and \$900; transferred to Bancroft factory, \$380 and \$170; transferred to Cranston factory, \$670, \$28, \$37, and \$400.

MACHINERY DISMANTLEMENTS

Cost	Depreciation Provided	Realized
\$400	\$260	\$ 75
370	190	60
70	60	15
680	370	300
800	590	250

Dies and Patterns—manufactured at factory, 700 patterns at \$16, 400 patterns at \$12, and 80 patterns at \$22 each. Transferred from White Plains factory, 60 patterns at \$12 each, and 20 patterns at \$22 each.

Transferred to Bancroft, 12 patterns at \$16 each and 26 at \$12 each; to Cranston factory, 20 patterns at \$22 each. Scrapped 550 patterns at \$16 each, depreciation provided, \$5,750; 300 at \$12 each, depreciation provided, \$2,160. Patterns scrapped had no salvage value.

Autos and Trucks—no change.

Office Furniture—purchases of \$340, \$80, \$56, \$17, \$30, \$25,

\$190, \$250, and \$16. No transfers. Scrapped items costing \$630, depreciation provided \$340, realized \$190.

(c) The White Plains factory accounts reflected the following transactions (transfers with Boston factory as above):

Land—no change.

Buildings—no change.

Building Fixtures—purchases of \$320, \$25, \$65, \$40, and \$75.

Machinery and Equipment—additions, purchases of \$1,120, \$50, \$850 and \$60. Transfers from Bancroft factory of \$800 and \$65.

Scrapped items—\$860 cost, depreciation provided \$385, realized \$200.

Dies and Patterns—Manufactured 750 at \$12, and 550 at \$16.

Transferred to Bancroft, 60 at \$12, 150 at \$16, and 50 at \$22 each. Scrapped a total of 75 at \$12, 65 at \$16, and 40 at \$22; total depreciation provided on all patterns scrapped, \$1,650.

Autos and Trucks—transfers as above. Scrapped one truck costing \$2,200, depreciation provided \$1,380, realized \$500.

Office Furniture—purchases, \$65, \$110, \$350, \$15, \$60, \$20, \$350, and \$480. Transferred from Bancroft Mfg. Co., \$550. Transferred to Cranston Novelty Co., \$380. Scrapped seven items aggregating: cost \$840, depreciation provided \$460, realized \$400.

(d) An examination of the subsidiary companies' books showed transfers as above, and certain other changes, as follows:

	<u>Bancroft</u>		<u>Cranston</u>	
Land		No change		No change
Buildings		do.		do.
Building Fixtures	Additions			do.
	(net)	\$ 483		
Machinery and Equipment	do.	1,200	Additions	\$1,800
Dies and Patterns	Deductions	800	Deductions	1,400
do.	Deprec. prov.	430	Deprec. prov.	1,060
Autos and Trucks		No change		No change
Office Furniture		do.		do.

It was ascertained from an examination of the records that the cost of patterns was based upon approximate costs, tests being made every three months of actual costs. All interplant and

intercompany transfers were made at cost price, but no accrued depreciation was transferred for any assets.¹

The depreciation rates for all factories are the same as those given above for the Philadelphia factory. The depreciation reserves as of August 31, 1926, for the other plants were as follows:

	Rate	White Plains Factory	Boston Factory	Bancroft Factory	Cranston Factory
Buildings	2½%	\$18,600	\$19,200	\$ 8,700	\$16,000
Building Fixtures	10%	6,350	7,240	4,100	3,860
Machinery and Equipment	10%	28,400	30,400	13,600	17,450
Dies and Patterns	17½%	36,750	24,250	18,450	23,600
Autos and Trucks	20%	2,100	1,750	1,800	2,160
Office Furniture	10%	4,600	2,200	1,260	1,490

The depreciation accrued on the Philadelphia plant for the portion of the 1926-27 fiscal year up to the date of sale of the property has already been included in the Reserve for Depreciation accounts. The aggregate charge to operations on account of this was \$4,380.

You are requested:²

(a) To outline briefly the procedure necessary to verify, for purposes of a balance sheet audit, the above property accounts.

(b) To sketch the forms of working schedules you would use, showing same for the Atchinson Manufacturing Company only.

(c) To prepare schedules showing the changes in the Atchinson Manufacturing Company's reserve for depreciation for the year ended August 31, 1927.

(d) To determine the total charge for 1926-27 to the consolidated profit and loss statement because of the property accounts. Show your analysis of the total.

(e) To prepare a schedule showing the values, for consolidated balance sheet purposes, of the Property accounts as of August 31, 1927.

¹ The management maintained that over a period of years the transfers to and from the various plants and companies are approximately equal, and it greatly simplifies the book-keeping not to make transfers of depreciation amounts accrued on transferred assets.

² See Federal Reserve Board bulletin, "Verification of Financial Statements," pars. 56 to 59. Jackson, *Audit Working Papers*, pp. 53-63, and Appendix A, schedules A-A⁶; Bell, *Auditing*, pp. 209-240; Reynolds and Thornton, *Duties of the Junior Accountant*, pp. 64-69; Hatfield, *Accounting*, pp. 82-86, 439-455.

All construction done by the company itself had been analyzed by the company's accounting department as follows:

COST OF PROPERTIES - CONSTRUCTION

Construction Order No.	Description	Materials	Labor	Burden	Total	% Com- pleted
	Totals				\$543,596.63	

The auditor thoroughly tested the material requisitions, and the distribution of the payrolls, and considered the manner of allocating burden expenses. Several of the larger orders were thus verified in detail; a few of the smaller orders were likewise analyzed. It was ascertained that in each month the percentage of burden (based on direct labor cost) was the same for capital construction as for manufacturing; this percentage ranged from 92% to 95% monthly. The report of the company's engineering department, as of December 31, 1928, regarding the per cent completed of the various construction orders, was seen; this report was accepted as correct. However, before the audit was completed (early in March, 1929) it was ascertained which of the construction orders in process at December 31, 1928 had been completed, and tests were made to determine that the estimates of the engineering department had been approximately correct.¹

The policy of the company was that all additions to the Property account, whether purchased or constructed, should be made upon authorizations properly approved by a responsible official; all authorizations of \$500 or less were signed by a vice-president; authorizations of \$500 to \$2,000 were approved by the president; and all authorizations of over \$2,000 were required to be approved by the executive committee. The authorizations of

¹ For example, if Construction Order A-8076 has had \$2,550 expended on it up to December 31, 1928, and was estimated by the Engineering Department as 85% completed, it should cost approximately \$450 to complete the work. If the cost to complete varied widely from this \$450 figure, the auditor would undoubtedly investigate quite carefully the reason.

the year were kept in a loose-leaf binder; these were examined by the auditor for approvals, and for comparison with the schedules of property additions prepared by the accounting department. The minutes of the executive committee also were examined for the larger appropriations. The auditor prepared summary schedules as follows:

COST OF PROPERTY - PURCHASES

(1)

Authoriza- tion No.	Purchase Order No.	Descrip- tion	Amount of Author- ization	Amount of Purchase	Invoice Seen (✓)	Authoriza- tion over or under

COST OF PROPERTY - CONSTRUCTION

(2)

Authori- zation No.	Construc- tion Order No.	Description	Amount of Authori- zation	Cost to Dec. 31, 1928	
				Material	
				Verified	Not Verified

(Cont'd)

Cost to Dec. 31, 1928				% Completed	Authori- zation over or <i>under</i>	Remarks
Labor		Burden	Total			
Verified	Not Verified					

Details were obtained for each construction order to support the "cost to Dec. 31, 1928" items in the summary schedule for construction. Except for several small clerical errors the analysis showed the company's records to be correct.

As the property verification neared completion, the auditor made a trip through the factory and had pointed out to him many of the additions of the period under audit. So far as this test extended all property additions of the period were in existence, and were being used for business purposes.

What criticism, if any, would you make of the above verification? Would you do more, and, if so, in what respect? Would you reject any of the client's methods as incorrect? If so, what, and why?

PROBLEM 38

CHARLOTTE MILLS, INCORPORATED—PART VI

Examination of the Minutes of Stockholders and Directors

During the early part of the audit, and especially in conjunction with the verification of capital assets, the minutes of the stockholders and directors were examined and all information having a bearing on the accounting of the company was carefully scheduled.¹ Your schedules resulting from the reading of the minutes were as follows:

DIRECTORS' MEETINGS

July 10, 1923—Regular Meeting

Resolution adopted authorizing the calling of a special meeting of stockholders for August 11, 1923 to vote approval of the proposed issue of 15,000 additional shares of 7% Cumulative Second Preferred Stock. (See Part XI of the Problem, page 294.)

Resolution adopted authorizing the erection of a new bleachery at Woburn Mill at an estimated cost of \$75,000.00; also an addition to the power plant, to supply the additional power required to oper-

¹ See Bell, *Auditing*, pp. 29-30; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 310-312; Jackson, *Audit Working Papers*, Appendix A, Schedules MM—MM2.

ate the new bleachery, at an approximate cost of \$20,000.00 (Authorization Nos. 22-724 and 22-725).

Resolution adopted authorizing the construction of a new weave shed at Melrose Mill, the approximate cost to be \$175,000.00 (Authorization No. 22-726).

Resolution adopted authorizing miscellaneous expenditures for additions to plant as per list presented by the president.²

August 11, 1923 – Special Meeting

Resolution adopted to accept the report of the stockholders' meeting, held August 11, 1923, at which the sale of 15,000 additional shares of 7% Cumulative Second Preferred Stock was authorized.

Resolution adopted authorizing the sale of 15,000 shares of 7% Cumulative Second Preferred Stock at par, as of October 1, 1923. Dividends cumulative from October 1.

August 25, 1923 – Regular Meeting

Resolution adopted authorizing the following capital expenditures at the Melrose Mill:

<u>Authorization No.</u>	<u>Description</u>	<u>Estimated Cost</u>
22-728 (a)	Shafting, belting and miscellaneous machinery	\$ 90,000.00
22-728 (b)	Openers, pickers, carders and spinning frames	168,000.00
22-729	Looms and installation costs	125,000.00
22-730	Cablers and special looms	45,000.00

Resolution adopted authorizing purchase for Woburn Bleachery of bleaching machinery at an estimated cost of \$115,000.00, and of dyeing machinery for \$80,000.00 (Authorizations No. 22-731 and No. 22-732).

September 20, 1923 – Regular Meeting

Resolution adopted authorizing a dividend of 3½% on 15,000 shares of Second Preferred Stock, payable October 1, 1923, to stockholders of record as of September 22, 1923. (See Part XII, p. 328.)

Officers re-elected for ensuing year. Two signatures required on checks and notes; treasurer or assistant treasurer, and comptroller or assistant comptroller.

Additional authorization to purchase bleaching and dyeing machinery for Woburn amounting to \$65,000.00 (Authorization No. 22-733).

² For authorizations involving smaller sums of money it is common practice to adopt a blanket resolution at each meeting of the directors to cover all such authorizations. The student may assume that all authorizations not specifically mentioned in the directors' minutes are covered by such blanket resolutions. See Part VII of the Problem, p. 235.

October 19, 1923 – Regular Meeting

Nothing affecting the accounts.

November 22, 1923 – Regular Meeting

Nothing affecting the accounts.

December 18, 1923 – Regular Meeting

Resolution adopted authorizing a dividend of 3% on 10,000 shares of 6% Cumulative First Preferred Stock, payable December 31, 1923, to stockholders of record as of December 20, 1923. (See Part XI, p. 293, and Part XII, p. 328.)

December 27, 1923 – Special Meeting

Resolution adopted authorizing the president to purchase at the market, 256 shares of the stock of the Amos Manufacturing Company. (See Part II, pp. 85, 87.)

January 19, 1924 – Regular Meeting

Nothing affecting the accounts.

February 21, 1924 – Regular Meeting

Nothing affecting the accounts.

March 18, 1924 – Regular Meeting

Resolution adopted authorizing a dividend of 3½% on 30,000 shares of Second Preferred Stock, payable April 1, 1924, to stockholders of record March 20, 1924. (See Part XI, p. 294, and Part XII, p. 328.)

April 20, 1924 – Regular Meeting

Nothing affecting the accounts.

May 19, 1924 – Regular Meeting

Nothing affecting the accounts.

Resolution adopted authorizing a dividend of 3% on 10,000 shares of First Preferred Stock, payable June 30, 1924, to stockholders of record as of June 20, 1924.

July 6, 1924 – Special Meeting

Resolution adopted approving all over-expenditures on authorizations for capital expenditures completed during the year, as per comptroller's list.

STOCKHOLDERS' MEETINGS

August 11, 1923—Special Meeting

Resolution adopted authorizing the sale as of October 1, 1923 of 15,000 additional shares of Second Preferred Stock, carrying a cumulative dividend of 7% per annum, payable semi-annually. Sale price shall be par or such higher price as board of directors may decide. Dividend to be cumulative from October 1. (See Part XI, p. 294.)

September 20, 1923—Annual Meeting

Directors elected for ensuing year; no changes were made.

Minutes of previous annual meeting were read, and approved as read.

Resolution adopted accepting the president's report for the fiscal year ending June 30, 1923; report ordered printed and distributed to stockholders of record.

Resolution adopted approving all acts of the directors, for and in behalf of the company, during the fiscal year ending June 30, 1923.

PROBLEM 39

CHARLOTTE MILLS, INCORPORATED—PART VII

Verification of Capital Assets and Reserve for Depreciation

In taking up the verification of capital assets you first make a study of the company's general accounting methods with reference to the property and plant accounts. You also ascertain from the general bookkeeper that the company has prepared general schedules of the additions to property during the year, of property scrapped or otherwise disposed of, and of depreciation. These schedules you obtain to aid you in the verification work; the schedules will be returned to the company when you have finished this part of your audit.

The Accounting Procedure

Your study of the general accounting for property and plant, and for current additions, gives you the following information:

During each year all changes in the capital assets accounts are recorded in the general ledger; at the close of each fiscal period these general ledger accounts are closed out to the private ledger.

The plant controlling accounts in the private and general ledgers are supported by subsidiary plant ledgers, showing for each of the seven mills the assets classified as follows:

Mill Structures	Machinery
Tenements	Transportation Equipment
Equipment	Furniture and Fixtures
Equipment—Technical	

A plant ledger card is kept for each plant unit within each of these groups in the various mills. These cards contain information as follows:

Card number	Labor
Plant unit symbol and number	Materials
Description and location	Miscellaneous costs
Authorization number	Total cost
Date purchased (or constructed)	Estimated useful life
Invoice number (if purchased)	Estimated productivity (in units
"A" order number (if constructed)	of product manufactured)
Purchase cost price	Accrued depreciation
Freight charges in	Maintenance cost (by years)

These cards are so grouped that the value of each class of capital assets and the total value of all such assets for each mill may be ascertained; the value of all capital assets for all mills agrees with the private ledger accounts (after all additions have been transferred from the general to the private ledger).

Other records affecting property and plant accounts are:

1. Authorization book.
2. Record of "A" orders issued.
3. Weekly summaries from the payroll department, showing all labor chargeable to plant additions.
4. Monthly summaries of materials requisitioned for plant additions.
5. Monthly summaries of purchases from outside concerns.
6. Monthly summaries of miscellaneous charges.
7. Completion reports.

1. Authorization Book

This book is a large scrap book kept in the general manager's office in which authorizations which have been approved are pasted. All capital expenditures of \$100 or more require an authorization signed by the president or vice-president, and by

the secretary or assistant secretary. All authorizations calling for an expenditure of \$25,000 or more must be approved by resolution of the board of directors; the smaller authorizations are approved periodically by a blanket resolution of the directors.

The authorization forms are 9" x 11" and contain the following information:

- Number
- Date submitted
- Description (Brief description of work to be done)
- Remarks (Reasons for the work and recommendations of various departments)
- References (List of engineering or other reports which accompany the authorization to the directors' meeting)
- Signature of president (or vice-president)
- Signature of secretary (or assistant secretary)
- Date of approval

As soon as the authorization is approved, it is sent to the general manager's office and pasted in the authorization book for permanent record.

2. Record of "A" Orders Issued

As soon as an authorization for plant additions is received from the president's office, the general manager's office issues an order to the engineering department to proceed with the work. These orders, which are known as "A" orders, are consecutively numbered; a record of all orders issued is kept in a book having the following columnar headings:

Number	Very brief description of
Date issued	proposed plant addition
Authorization number	Reference file number

The reference file number relates to the folder which contains all information relative to the work, such as specifications, blueprints, etc. These folders are numbered consecutively, and are filed numerically.

3. Weekly Summaries of Labor Charges

The payroll department makes up weekly, from the time cards or time books, a summary of all labor charges applicable to each

"A" order. A copy of this summary is used as a basis for the debit postings to the subsidiary plant control accounts, and for the credit to the Payroll account. The charges to the individual plant unit cards are also posted from this list, after which the list is filed in a loose-leaf binder.

4. Monthly Summary of Stores Requisitions

This summary is prepared by the stores department and is similar in content to the labor summary described above, and is used and filed in the same manner.

5. Monthly Summary of Outside Purchases

This summary contains a list of all outside purchases made for plant account. It is prepared by the accounts payable department, and contains detailed information as follows:

"A" order number ¹	Amount of purchase
Voucher number	Freight or express
Vendor	Total cost
Description of purchase	

This monthly summary is also used as the basis for a plant charge, and postings to the plant unit cards are made from it.

6. Summary of Miscellaneous Charges

This summary is prepared monthly by the cost department and includes, under each "A" order number, all overhead charges applicable to plant additions for the month, together with a brief description of the charge. It is used as above described.

7. Completion Reports

The engineering department sends a completion report to the comptroller's office as soon as each "A" order is finished. Also, at the end of the fiscal year the department prepares a list of all incomplete "A" orders, stating thereon the estimated percentage of work completed on each order and the estimated cost to complete the addition.

The Actual Audit

Turning to your previous year's working papers, you have the following summary of property and plant:

¹ Under each "A" order number are grouped all purchase invoices applicable to that order.

CHARLOTTE MILLS, INCORPORATED

Summary of Properties

June 30, 1923

Plant	Land	Mill Structures ²	Equipment	Equipment-Technical	Machinery	Transportation Equipment	Furniture and Fixtures	Totals
Arlington	\$ 104,765.90	\$ 214,292.48	\$ 517,004.46	\$ 342,395.91	\$ 834,926.07	\$ 267,005.70	\$ 56,809.57	\$ 1,707,798.48
Boston	860,000.00	1,094,605.19	905,947.02		3,630,981.20		178,926.83	7,279,861.85
Cambridge	206,500.00	337,500.32	407,312.36		763,084.63		40,026.93	1,754,424.24
Charlestown	27,605.47	340,965.07	330,422.43		593,283.59		32,946.05	1,325,222.61
Dorchester	326,000.00	660,524.31	731,505.89		2,906,011.37		59,328.41	4,683,369.98
Melrose	200,000.00	501,620.83	711,026.85		1,251,206.15		47,996.09	2,711,849.92
Woburn	132,819.00	477,021.64	598,701.13		1,007,398.45		39,024.50	2,254,964.72
Office				17,698.26		14,650.00	60,983.14	93,331.40
Totals	\$1,857,690.37	\$3,626,529.84	\$4,201,920.14	\$ 360,094.17	\$ 10,986,801.46	\$ 281,655.70	\$ 496,041.52	\$ 21,810,823.20

² Tenements are included, in the account classification, in the Mill Structures account.

Illustration of Audit

To illustrate the procedure followed in verifying the additions of the year, an analysis of "Mill Structures, Melrose" is given below. The plant ledger account appeared as follows:

MILL STRUCTURE—MELROSE

1923				1923			
June 30	Balance		501,620.83	Sept. 30	A 126	J 141	17,097.71
Oct. 31	A 694	J 209	60,000.00				
Dec. 30	A 694	J 246	60,000.00				
1924							
Feb. 28	A 694	J 297	60,620.00				
May 31	A 695	J 365	4,560.75				

The ledger postings are made from the journal; journal entries are made from journal vouchers, in which are given the "A" order number, the numbers and amounts of all vouchers for outside purchases, and the total labor and other charges made to the "A" order, together with the dates and numbers of the summary records from which these charges were taken.³

You took the journal, therefore, and, turning to the pages designated in the ledger folio column, prepared a list of the journal voucher numbers. This list you then handed to the filing department, which furnished you with the vouchers requested.

From these journal vouchers you next prepared a list of the numbers of all purchase vouchers amounting to \$1,000 or over; sufficient smaller amounts were included to constitute a quite thorough test, for such smaller items are more apt to be chargeable to expense. This list was given to the file clerk, who obtained the vouchers from the files and delivered them to you.

These were examined by you to see that the purchases were proper charges to additions. Catalogues containing descriptions and prices of textile machinery and supplies were used in checking the larger purchases. This was done to see that repair parts were not charged to plant additions and that the prices on the vouchers were not excessive.

Charges for labor, materials, freight in, and overhead, which were referred to in the journal vouchers, were checked to the

³ The methods of accumulating costs of capital additions will vary greatly in different concerns; the method described here, as used by this company, is perhaps a little unusual but nevertheless typifies a procedure sufficiently common to merit careful study.

various summaries and the summaries were later tested with the original labor tickets, material requisitions, etc., to see that the charges were properly made.

The journal voucher from which the credit of \$17,097.71 had been made stated that this amount represented the original cost of a building demolished; "A" order No. 126 (credit "A" orders are prepared on the regular "A" order form, but on differently colored paper) showed that the total amount had been charged against Reserve for Depreciation. The plant unit card was also obtained; it showed \$17,097.71 as the original cost, but accrued depreciation to date of dismantlement was only \$6,341.20. The "completion report" showed that materials and supplies were recovered to the amount of \$7,420, and that all costs of demolition were charged to expense. The general storeskeeper, in answer to a memorandum which you sent him, replied that the supplies were still on hand but were not included in the inventory at June 30. He also stated that \$7,420 was the second-hand value of the items and that they were usable. From this information you draft the following adjusting journal entries:⁴

(1)

Materials and Supplies	\$7,420.00	
To Mill Structures		\$7,420.00
(Melrose Mill \$7,420.00)		
For materials recovered in demolishing building at Melrose under A 126.		

(2)

Mill Structures	\$10,756.51	
(Melrose Mill \$10,756.51)		
To Reserve for Depreciation		\$10,756.51
To credit Reserve for Depreciation for excess charge for depreciation on building demolished at Melrose under A 126.		

⁴ Except for the additional information provided, a single entry might have been made, viz.:

Material and Supplies	\$7,420.00	
Loss on Dismantlement	3,336.51	
To Reserve for Depreciation		\$10,756.51
(With explanations.)		

This alternate journal entry is more simple, and the three entries given inflate the Mill Structures account by \$10,756.51. The net result is, however, correct in either case.

	(3)	
Loss on Dismantlement	\$3,336.51	
To Mill Structures		\$3,336.51
(Melrose Mill \$3,336.51)		
To charge to a special Profit and Loss account the difference between the original cost of the building demolished under A 126, and the sal- vage value plus accrued depreciation as follows:		
Original Cost	\$17,097.71	
Materials received	\$7,420.00	
Depreciation accrued	6,341.20	13,761.20
Charge to special P. & L. at		<u>\$ 3,336.51</u>

The results of this verification work was then properly recorded in your schedules; the adjusting journal entries were made in regular order on working sheets wholly reserved for them, while the additions to and deductions from the Melrose Mill structures were briefly scheduled on separate working sheets.

The Work To Be Done

To reduce to a minimum the verification work for these Capital Asset accounts, the student should assume a verification procedure for each item about as outlined above for "Mill Structures - Melrose." This entire verification might require the time of two or more assistants for a number of days or weeks; the summarized results of the work are given below:⁵

LAND

Arlington Mill. A lot of land in Arlington was sold at cost to John Smith on October 31, 1923, for cash \$7,000.00. This land was subject to the mortgage securing the company's outstanding first mortgage 7% bonds; the money received was deposited with the First Trust Co. (Trustee) in order that the land might be released from the mortgage and a clear title given.

MILL STRUCTURES

Arlington Mill. A 529-Structure, connecting buildings A and B. Outside purchases v. \$325.20; other charges v. \$298.70; n.v. \$56.10. Work completed.

A 1-Receiving platform at building No. 1. Outside purchases v. \$126.00; other charges v. \$340.17; n.v. \$63.94. Work completed.

⁵ Abbreviations are used as follows: "v." for "verified," meaning that expenditures or credits to that extent were "vouched" or verified; "n.v." for "not verified," meaning that this amount, usually made up of numerous small items, was not "vouched" or verified.

Boston Mill. A 419—Retaining wall behind weave shed. Outside purchases v. \$4,627.33; n.v. \$467.90; other charges v. \$10,946.72; n.v. \$552.25. Work completed.^o

Cambridge Mill. A 141—Installation of new elevator. Paid Otis Elevator Co. v. \$8,694.00. Work completed.

Charlestown Mill. A 172—Additions to receiving and opening rooms. Outside purchases v. \$4,946.20; n.v. \$1,220.94; other charges v. \$6,-227.11; n.v. \$1,326.69. Work completed.

Dorchester Mill. A 554—Installation of sprinkler system. Paid National Sprinkler Co. v. \$9,901.81. Work completed.

Melrose Mill. A 694—Erection of new weave shed. Paid Boston Contracting Co. three instalments of \$60,000.00 each and was told that \$620.00 was charged to the order for supervision. Work completed. Verified.

A 695—Addition to power plant. Outside purchases v. \$1,295.60; n.v. \$126.37; other charges v. \$2,807.98; n.v. \$330.80. Work 80% completed; estimated cost to complete, \$1,420.00.

Credits. A 126—Building demolished to make room for new weave shed, \$17,097.71. Materials and supplies valued at \$7,420.00 were salvaged from the building and were sent to the Supply Storehouse; you find, however, that they were not included in the inventory at June 30, 1924, and that the total of \$17,097.71 was charged against the Reserve for Depreciation. Depreciation accrued on this building, per the plant ledger card, was \$6,341.20; this amount, based upon the results of previous audits, you found to be correct.

Woburn Mill. A 712—Erection of new bleachery. Eleven payments of \$5,000.00 each have been made to the Boston Contracting Co. All work has been completed and has been accepted by the company; a payment of \$20,000.00 is due July 5, 1924. This amount has not been charged to Mill Structures. Verified.

A 713—Power plant additions. \$15,000.00 paid to Boston Power Plant Co.; outside purchases n.v. \$178.45; other charges v. \$3,657.19; n.v. \$1,342.81. Work 99% completed; estimated cost to complete, \$195.00.

TENEMENTS

Arlington Mill. A 219—Installation of electric lights in tenements. Materials purchased from General Electric Co. v. \$756.90. Work 35% completed; estimated cost to complete, \$900.00.

Charlestown Mill. A 220—Installation of electric lights. Outside purchases v. \$429.35; labor charges v. \$485.30; other charges n.v. \$97.72. Work completed.

Dorchester Mill. A 221—Installation of electric lights. Materials purchased from General Electric Co. v. \$400.00; other charges n.v. \$15.93. Work 25% completed; estimated cost to complete, \$1,584.07.

^o See Jackson, *Audit Working Papers*, Appendix A, Schedules A¹ and A⁴, for a method commonly used of scheduling these various items of capital additions.

EQUIPMENT

Arlington Mill. A 76—Additional trucks and containers. Purchases from Fairbanks Co., voucher 9273 examined, \$926.30. Authorization completed.

Boston Mill. A 426—New motors and installation on new looms. Outside purchases v. \$7,642.91; n.v. \$237.56; other charges v. \$5,840.90; n.v. \$37.84. Work completed.

Cambridge Mill. A 701—Bobbins for new style yarn. Outside purchases v. \$5,693.70; n.v. \$828.43. Authorization completed.

Charlestown Mill. A 148—Changing over boilers to burn oil. Paid Oil Burner Co. \$6,950.75; other charges n.v. \$348.01. Work completed.

Dorchester Mill. A 149—Changing over boilers to burn oil. Paid Oil Burner Co. \$8,760.22; other charges n.v. \$200.35. Work completed.

A 646—New motors and installation. Outside purchases v. \$1,-270.24; other charges v. \$3,960.72; n.v. \$534.52. Work 50% completed; estimated cost to complete, \$5,000.00.

Melrose Mill. A 699—Shafting, belting, power transmission lines, etc., and their installation. Paid Textile Machinery Corp. \$87,640.00. Other outside purchases n.v. \$2,623.90; other charges v. \$1,000.00 (engineering supervision). Work 98% completed; estimated cost to complete, \$3,200.00.

A 703—Trucks and containers. Purchases from National Fibre Co. v. \$4,920.00. Authorization completed.

A 704—Reeds, harness, and other equipment for new looms. Outside purchases v. \$11,950.75; n.v. \$853.04. Work 93% completed; estimated cost to complete, \$2,500.00.

Transfer No. 699 of 3-250 H.P. motors from Woburn, \$2,390.50. The moving cost was charged to Expense.

Woburn Mill. A 700—Bleachery and dyeing equipment. Purchased from Textile Machinery Co. v. \$65,000.00. Authorization completed.

A 705—Cloth trucks and racks. Outside purchases v. \$2,150.15; n.v. \$176.05. Work 25% completed; estimated cost to complete, \$6,000.00.

Credits. Transfer No. 699 of 3-250 H.P. motors to Melrose Mill. Original cost was \$2,390.50 set up. Checked to plant unit card and card transferred to Melrose section of ledger.

EQUIPMENT—TECHNICAL

Operating Office. A 562—Humidifier and cotton testing apparatus. Outside purchases v. \$350.00. Authorization completed.

MACHINERY

Arlington Mill. A 712—Installation of Creighton openers. Outside purchases v. \$3,020.60; other charges v. \$1,275.58; n.v. \$341.10. Work completed.

Boston Mill. A 771—New cablers and installation. Outside purchases v. \$14,926.71; n.v. \$659.40; other charges v. \$2,012.36; n.v. \$110.79. Work completed.

Transfer No. 623—Spinning frames from Woburn; cost per plant card \$23,765.00.

Cambridge Mill. A 89—New openers and installation. Outside purchases v. \$12,620.72; n.v. \$1,204.50; other charges v. \$2,080.27; n.v. \$690.15. Work 98% completed; estimated cost to complete, \$500.00.

Charlestown Mill. A 640—Roving frames and installation. Outside purchases v. \$7,250.00; other charges n.v. \$146.31. Work 50% completed; estimated cost to complete, \$7,000.00.

Melrose Mill. A 941—Openers, carders, spinning frames, etc. Paid Saco-Lowell Shops v. \$142,920.35; other purchases n.v. \$3,940.29; other charges v. \$6,210.91; n.v. \$450.00. Work 95% completed; estimated cost to complete, \$15,000.00.

A 942—Looms and installation. Paid Draper Loom Corp. v. \$95,640.00; other purchases n.v. \$4,957.62; other charges v. \$12,630.43; n.v. \$995.37. Work 93% completed; estimated cost to complete, \$18,500.00.

A 943—Cablers and special looms and installation. Paid Crompton-Knowles Loom Works, v. \$42,000.00; other charges v. \$620.17; n.v. \$3,640.91. Work completed.

Transfer No. 631 of looms from Woburn Mill. Original cost \$41,000.00. Moving cost charged to expense.

Woburn Mill. A 944—Bleaching machinery. Outside purchases v. \$103,617.20; n.v. \$2,941.67; other charges v. \$3,028.05; n.v. \$450.00. Work completed.

A 945—Dyeing machinery. Paid Textile Machinery Corp. v. \$35,955.55; other charges n.v. \$526.52. Work 47% completed; estimated cost to complete, \$45,000.00.

Credits

Boston Mill. AS 621—Machinery sold for cash, \$18,854.20. This account was further credited for this machinery sold, \$57,747.19, and the Reserve for Depreciation was charged. This amount was found to be the difference between the original cost of the machinery sold and the selling price. The depreciation actually accrued to date was \$36,526.00.

Woburn Mill. Spinning frames originally costing \$23,765.00 were transferred to Boston Mill; looms originally costing \$41,000.00 were transferred to Melrose.

TRANSPORTATION EQUIPMENT

Operating Office. A 590—Two 5-ton trucks. Paid Auto Sales Corp. v. \$4,000.00.

A 592—1 Hudson Sedan for official use. Paid Hudson Motor Sales Co., v. \$2,000.00.

Credits. AS 41—Hudson Sedan sold for \$800.00. Depreciation written off \$1,200.00, making total credits of \$2,000.00 which was the original cost of the car.

FURNITURE AND FIXTURES

Operating Office. A 94—Glass partition. Outside purchases v. \$200.00; other charges v. \$247.20; n.v. \$95.00. Work completed.

The Authorizations

The following authorizations for the year under audit were found in the authorization book:

<u>Mill</u>	<u>Auth. No.</u>	<u>A No.</u>	<u>Description</u>	<u>Amount Authorized</u>
Arlington	22-621	529	Structure connecting buildings A & B . . .	\$ 750.00
	23-002	1	Receiving platform at building A . . .	500.00
	23-119	219	Installation of electric lights . . .	1,500.00
Charlestown	23-120	220	" " " " . . .	1,200.00
Dorchester	23-121	221	" " " " . . .	2,000.00
Boston	22-326	419	Retaining wall behind weave shed . . .	15,000.00
Cambridge	23-102	141	Installation of new elevator . . .	8,500.00
Charlestown	23-116	172	Additions to receiving and opening rooms	14,000.00
Dorchester	22-629	554	Sprinkler system . . .	10,000.00
Melrose	22-726	694	Erection of new weave shed . . .	175,000.00
	22-727	695	Addition to power plant . . .	6,000.00
Woburn	22-724	712	Erection of new bleachery . . .	75,000.00
	22-725	713	Addition to power plant . . .	20,000.00
Arlington	23-49	76	Additional trucks and containers . . .	1,000.00
Boston	22-317	426	Motors and installation for new looms . . .	13,900.00
Cambridge	22-632	701	Bobbins for new style yarn . . .	6,500.00
Charlestown	23-122	148	Changing boilers to burn oil . . .	7,500.00
Dorchester	23-123	149	" " " " . . .	9,000.00
Transfer		699	3-250 H.P. motors - Woburn to Melrose	1,000.00
"		623	Spinning frames - Woburn to Boston . . .	6,000.00
		631	Looms - Woburn to Melrose . . .	2,000.00
Dorchester	23-927	646	Motors and installation for new looms . . .	10,000.00
Melrose	22-728 (a)	699	Shafting, belting, power transmission, etc.	90,000.00
	23-590	703	Trucks and containers . . .	5,000.00
	23-591	704	Reeds, harnesses, etc., for new looms . . .	15,000.00
Woburn	22-733	700	Bleaching and dyeing machinery . . .	65,000.00
	23-592	705	Cloth racks and trucks . . .	8,700.00
Operating Offices	23-420	562	Cloth testing apparatus . . .	350.00
	23-510	590	2 5-ton trucks . . .	4,000.00
	23-516	592	1 Hudson Sedan . . .	2,000.00
	22-121	94	Office partitions . . .	500.00
Arlington	22-691	712	Installation of Creighton openers . . .	5,000.00
Boston	22-700	771	New cablers and installation . . .	17,500.00
Cambridge	23-7	89	New openers and installation . . .	17,000.00
Charlestown	23-622	640	Roving frames and installation . . .	14,000.00
Melrose	22-728 (b)	941	Openers, cards, spinning frames, etc . . .	168,000.00
	22-729	942	Looms and installation . . .	125,000.00
	22-730	943	Cablers and special looms . . .	45,000.00
	22-734	126	Demolish building on site of weave shed	1,000.00
Woburn	22-731	944	Bleaching machinery . . .	115,000.00
	22-732	945	Dyeing machinery . . .	80,000.00

Depreciation

There was no change in the private ledger Reserve for Depreciation account. Your previous audit papers state that this reserve was set up in June, 1922, because an appraisal of the Woburn Mill showed that the value on the books of the company less accrued depreciation was \$300,000 in excess of the replacement value reported by the appraisal company.

There are approximately 484,685 spindles in all of the company's mills and the depreciation was accrued for the current year at approximately \$1.11 per spindle. You find a monthly credit of \$45,000 to Reserve for Depreciation in the general ledger, and total miscellaneous debits amounting to \$76,044.90. In the textile industry it is customary to speak of the capacity and size of a mill in terms of spindles. Depreciation in many cases is therefore computed on a spindle basis; the comptroller claimed that, considering the kind of construction, type of machinery and age of the company's plants, the annual depreciation rate of \$1.11 per spindle was adequate.

You, however, sought further information, and found in *The Accountant's Index Supplement*, 1921-23, p. 160, under the caption of "Cotton Mills," the following statement: "Depreciation of machines should be calculated by departments on the basis of the expected life of each machine. The more common basis, however, is at a fixed rate of up to \$1.50 a spindle."⁷

The Accountant's Index, p. 635, gives the following depreciation rates for the textile industry:⁸

Buildings	3%
Machinery	4%

On the basis of these and other suggested rates of depreciation, and after considering all pertinent facts regarding this company's assets you believed that the minimum depreciation which should have been accrued for the year under audit was \$650,000 to \$700,000.

At an opportune time you took up the matter with the comptroller and other executives of the company. These officers ad-

⁷ Percival F. Brundage, "Distinctive features of cotton goods accounts," *Journal of Accountancy*, Vol. XXXI, No. 4 (April, 1921), p. 270.

⁸ *The Accountants' Index* and the two *Supplements* (1921-23 and 1923-27) are published by the American Institute of Accountants, 185 Cedar Street, New York, N. Y. These three volumes represent the best existing bibliography of accounting literature.

mitted that the company's plants had operated at high capacity all year; it was also agreed that there was no reason why the company's capital assets would not have depreciated a normal amount during the year past. It was finally agreed that the depreciation provision for the year should be increased to \$650,000 and that this amount should be shown in the operating statement as the depreciation cost of the year.

Goodwill, Trade-Marks, Patents, etc.

There has been no change in this account during the year. An examination of the ledger account shows that in previous years it had been charged with all expenses incurred with regard to patents and similar items, and that such amounts had been immediately charged to Surplus except for a \$1.00 balance.

Examine critically all verification work done with reference to the capital assets, particularly as regards the additions, transfers, and dismantlements of the period. Should any further verification be made of these accounts, and, if so, outline specifically what further work you consider necessary.⁹

Prepare summary working schedules, showing in usable form all data necessary or desirable for the satisfactory completion of the audit. Make notes in your working papers of any matters which you believe should be included in your report to the client.

PROBLEM 40

GROTON MANUFACTURING COMPANY

Property Construction

The Groton Manufacturing Company, which manufactures cotton yarns and cloth, voted an authorization of \$30,000 to build and equip a one-story dye shop. The plant was erected, and the cost charged to the buildings account in the company's general ledger.

⁹ See Jackson, *Audit Working Papers*, pp. 50-63, and Appendix A, Schedules A-A6; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 200-237; Dickinson, *Accounting Practice and Procedure*, pp. 75-82; Bell, *Auditing*, pp. 209-240; Hatfield, *Accounting*, pp. 82-86.

During the annual audit of the company's accounts the auditor analyzed the year's construction, and made a detailed verification of the larger items. The authorization for the dye shop was examined; invoices were seen for all materials purchased for the construction, payroll distributions were examined for the labor charges, and it was ascertained that the burden had been distributed to the order on an equitable basis. The records and accounts were correct, so far as this addition was concerned.

However, the auditor made his usual inspection of the plant before the close of his audit; he did not find any new dye shop, but was surprised to find a new garage which did not appear in the accounts. Inquiry revealed that the authorization was voted for the dye shop, and the construction completed in anticipation of a large order for dyed goods. The order did not materialize, however, and upon the completion of the building it was decided not to equip it, but to use it as a garage. A garage of the same size and type of construction would not have cost more than \$15,000 at the time the dye shop was built.

The auditor believed that the excess expenditure of the cost of constructing a garage of the same size and type of construction was caused by an error either in management or in judgment, and that it did not add to the productive capacity of the plant. It should, therefore, have been a charge against the operations of the year, and should not have been capitalized.

The treasurer admitted that the expenditure was excessive for a garage, but maintained that there was still a probability that the building would be used for the purpose for which it was constructed. After further discussion, however, it was admitted that the company gambled in constructing the shop and that it would be a much more conservative policy on the part of the company to write down the cost to the \$15,000 value. The auditor, therefore, recommended that obsolescence be taken up in the books for \$15,000; this represented the difference between the actual cost of the dye house and the estimated cost new of a garage of similar capacity. This would enable the company to carry the dye house in its general and plant ledgers at \$30,000; the obsolescence would be carried separately in the books, but would be deducted from the asset value before the latter figure was reflected in the balance sheet.

Comment upon the above procedure; if you object, how would you support your objections? Suppose the company later decided to use the building for a dye house; what adjustment, if any, should then be made in the accounts?

PROBLEM 41

DEANE LUMBER COMPANY

Appreciation of Fixed Assets

The Deane Lumber Company wished to record in its books of account, as of December 31, 1922, the estimated appreciation in the value of its sawmills and timber holdings since their acquisition. The board of directors accordingly requested Messrs. McKee, Haston & Co., Public Accountants and Auditors, for an opinion with regard to recording such appreciation in the company's accounts.

The auditors stated in their report that not infrequently a large part of the ultimate profits of a corporation such as The Deane Lumber Company results from this unearned increment.¹ Such ultimate profits, however, are not actual profits until realized, and should not reasonably be taken into the profits.

This does not mean that it is not quite proper, for various purposes, to recognize the increase in value. It is usually preferable that such increased value be omitted entirely from the books of account; however, if the company insists on having such appreciation recorded in the accounts, the property should be appraised by a reputable appraisal company and the estimated appreciation credited to a Capital Surplus from Appreciation, or similar account. This appreciation surplus may, if desired, be capitalized, but until actually realized should not be distributed in any other form of dividend.² To distribute such a surplus in cash would unduly deplete the current assets—by an amount equal to the estimated increase in the value of the fixed assets which may never be realized—a most unwise procedure and one which might prove disastrous.

When estimated appreciation in the value of fixed property

¹ See Dickinson, *Accounting Practice and Procedure*, pp. 81-82.

² It is even probable that until the appreciation is realized it would be illegal, certainly in many states, to distribute it as cash dividends. See, on this point, Hatfield, *Accounting*, pp. 282-284.

has once been recorded in the accounts, a somewhat larger annual credit to the corresponding reserve for depreciation (or depletion) account will be necessary. The reason for this is obvious: the life of the asset has not been lengthened by writing up its value, yet there is a larger value to be written off. The auditors stated in their report:

We are of the opinion that this increase in depreciation of the sawmills should not be taken into the manufacturing or other operating costs. Only such an amount should be included in current costs as measures the depreciation (or depletion) of the property or equipment at actual cost. Replacement values should be permitted to affect the costs only from the date of replacing the property; they apply only to the life of the replaced plant.

To state the matter differently, the cost of doing work or of producing commodities includes the loss from the physical and functional depreciation of the fixed assets used in the process, and this depreciation occurs during the life of these particular assets. The fact that the assets cannot be replaced at the same cost, but only at much more, has nothing to do with the cost of present product, but only with the cost of future product turned out by the subsequent plant. True cost, therefore, can be obtained only by including as total depreciation the loss based on the original cost of the equipment.

These properties were all acquired near the close of 1914. If, therefore, it be assumed that the sawmills alone cost \$1,000,000 in 1914, it may be said that this value had risen approximately to \$2,800,000 in 1919, had declined to \$2,300,000 in 1920, and perhaps to \$1,950,000 by the end of 1921. Now if it is desired to record in the accounts the real cost of producing lumber, must the company go back and revise its costs for each of these past years? "We submit," stated the report, "that it did not actually cost more in 1919, and less in 1920 to produce lumber—at least not merely because the estimated replacement value of the properties increased in one year and decreased in the next. The cost of the sawmills did not change." The report continued:

The fact that true cost can be obtained only by using a depreciation charge based upon the original cost of the plant does not mean, however, that prices must be fixed on the cost figures so found. This would mean that the customer would get the use of low-cost plant in the days of high-cost plant. It is not a question of account-

ing, but of business policy, whether the manufacturer or the customer shall have this advantage. . . . True costs are obviously considerably lower in the case of these sawmills than they would be if the depreciation charge to operations were made on the basis of replacing the present physical plant; accordingly, unless a somewhat greater percentage is added to the cost of producing lumber to obtain selling price, the customer will receive the benefit of the manufacturer's purchasing and installing this plant when prices were lower than now. Actual cost, however, is a fact, whichever policy is adopted; true cost cannot change so far as the depreciation expense is concerned.

The report of the auditor then discussed the bookkeeping entries which were necessary to record the appreciation of the sawmills as of December 31, 1922. The properties had been continuously operated during the eight years of their ownership by the Deane Lumber Company, and had been depreciated during that time at the rate of 5% per annum. The reserve for depreciation account stood credited in the books for \$400,000, leaving a net book value for the sawmills of \$600,000. This amount represented 60% of the original cost of the properties.

The properties had been appraised at a net depreciated value of \$900,000, which represented 60% of the replacement value of the properties new. This meant that the sawmills, costing \$1,000,000 and standing in the accounts at that figure, had a replacement value new of \$1,500,000.

The auditor stated that the result of the appraisal might be recorded in the accounts either by closing the present Reserve for Depreciation into the Sawmill Properties account, and then writing up the properties and crediting an appraisal surplus account for the \$300,000 appreciation in the net depreciated value of the mills, or by bringing into the books the replacement value new of the assets. The latter method was recommended in the report, and the following entry was suggested:

Sawmill Properties	\$500,000.00	
To Capital Surplus from Appraisal		\$500,000.00
To record the increase in property values as per appraisal -		
Replacement value new	\$1,500,000.00	
Book value (cost) . . .	<u>1,000,000.00</u>	
Capital Surplus	\$	500,000.00

The above does not include any possible increase in value of the timber holdings. In such case the question arises whether any increase in value is entirely because of market changes or whether it may be in part such carrying charges as taxes, interest (especially interest paid) on the original investment, and similar charges. The increase from carrying charges would usually have been already included in the timber holdings account, and only market changes would be reflected as a result of appraisal. The auditor's report further continued:

To adjust properly the accounts it is necessary at once to transfer from the Capital Surplus from Appraisal account to the Reserve for Depreciation account such an amount as will represent the accrued depreciation on the increased value at 5 per cent annually for eight years, viz.:

Capital Surplus from Appraisal	\$200,000.00	
To Reserve for Depreciation		\$200,000.00
To record eight years' depreciation at 5 per cent on the booked increase of \$500,000.00 in the replacement value of sawmills.		

The property accounts will now show the following results:

Sawmills (replacement value new)	\$1,500,000.00
Less: Reserve for Depreciation	600,000.00
Net replacement value	<u>\$ 900,000.00</u>
Deduct:	
Capital Surplus from Appraisal	300,000.00
Sawmills (at depreciated cost)	<u>\$ 600,000.00</u>

By this procedure, the property account less the Reserve for Depreciation gives the appraised depreciated value of the asset; this information the company desires for purposes of insurance, sale, or credit. The depreciated cost value may also be had by further deducting the balance in the Capital Surplus from Appraisal account, and this is what should be used for cost purposes.

* * * *

It is now proper procedure to credit the Reserve for Depreciation with amounts based upon the new book value, charging to Depreciation that portion which is applicable to the original cost (book) value, and to Capital Surplus from Appraisal the balance. This means that the appraisal surplus is amortized into the Reserve for Depreciation, so that at the end of the estimated life of

the property affected, the Reserve for Depreciation will extinguish the asset value (less such scrap value as may have been estimated) as though no appreciation had been recorded in the books of account. Furthermore, by such procedure the Company has had any credit advantage arising from the increased value of the property.

The depreciation account thus records each year the portion of the actual investment in plant which is transferred to operating costs. The reserve for depreciation account records the expired portion of plant based upon the appraised replacement value new of the property; a portion of this (that representing cost) has been charged to operations, while a portion (that representing the appraisal increase) has been used to extinguish the Capital Surplus from Appreciation. The report concluded:

This brings the Capital Surplus from Appreciation into the Earned Surplus over the entire life of the property, instead of making the whole transfer at the end of the period. This is as it should be.

Is the auditor's report sound, with reference to (a) the placing of appraisal values upon the books, (b) the charges to be made to cost for depreciation, and (c) the book entries affecting the Capital Surplus from Appreciation? ³

PROBLEM 42

NANKING HOTEL COMPANY

Appreciation of Real Estate

In 1904, H. L. Jamieson and J. K. Barnes purchased an unimproved piece of real estate in the city of Chicago for \$100,000. During the years intervening, the population had moved rapidly in that direction, so that by 1927 the land was estimated to have a valuation of \$1,000,000. Jamieson and Barnes contemplated organizing the Nanking Hotel Company, provided they could raise sufficient funds to build the type of apartment hotel they

³ See Hatfield, *Accounting*, pp. 77-78, 252, 280-285; Bell, *Auditing*, pp. 225-228; *Journal of Accountancy*, Vol. XXIX (June, 1920), pp. 452-455; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 208-209.

believed that section of the city demanded; they required a statement of financial condition, prepared by a well-known firm of accountants, which they might present to banking interests.

The accountant suggested that the balance sheet might be prepared somewhat as follows:

JAMIESON AND BARNES
BALANCE SHEET, OCTOBER 31, 1927

Land at cost	\$100,000	Proprietorship	\$100,000
	<u>\$100,000</u>		<u>\$100,000</u>
NOTE: The above land has been appraised by the Simmons Appraisal Company as worth \$1,000,000.			

Messrs. Jamieson and Barnes objected to this balance sheet, stating that the asset they owned was worth \$1,000,000 and that this was the figure which they desired to have shown in the body of the balance sheet. The accounting firm thereupon changed the balance sheet, so that it appeared thus:

JAMIESON AND BARNES
BALANCE SHEET, OCTOBER 31, 1927

Land, at appraised value, as determined by the Simmons Appraisal Company	\$1,000,000	Proprietorship	\$1,000,000
	<u>\$1,000,000</u>		<u>\$1,000,000</u>

This balance sheet also was unsatisfactory to Messrs. Jamieson and Barnes; they did not desire to have the words, "at appraised valuation, as determined by the Simmons Appraisal Company," appear in the statement. The accountant maintained that either of these balance sheets told the actual truth, and that only in some such form could his firm certify the statement without qualification.

It was suggested, however, that since Messrs. Jamieson and Barnes were planning to organize the Nanking Hotel Company they proceed with the organization, and then present to their bankers the balance sheet of the corporation.¹ The Nanking

¹ "Property values are so largely a matter of personal opinion, and practices with regard to depreciation and to capitalization of additions and betterments are so variable, that it has

Hotel Company was accordingly organized under the laws of Illinois, the sole asset of the company being the real estate previously owned by Jamieson and Barnes. The capital stock was all issued, subject to directors' qualifying shares, to Messrs. Jamieson and Barnes. A new balance sheet was then prepared, as follows:²

NANKING HOTEL COMPANY
INITIAL BALANCE SHEET, NOVEMBER 30, 1927

Land	\$1,000,000	Capital Stock	
Organization expense	5,000	Authorized - 200,000	
		shares of no-par value.	
		Outstanding - 150,000	
		shares	\$1,005,000
	<u>\$1,005,000</u>		<u>\$1,005,000</u>

The accounting firm certified this balance sheet in the following terms:

We have examined the articles of organization, the charter, and the records of the Nanking Hotel Company and WE CERTIFY THAT in our opinion the above initial balance sheet fairly states the financial position of the company as of November 30, 1927.

(Signed) AUDITORS

Chicago, December 12, 1927

Certified Public Accountants

Do you approve the accountants' procedure? What difference did the organization of the Nanking Hotel Company make?

become quite customary when a business is reorganized or refinanced to have an independent appraisal of its property made and to adjust the accounts accordingly. Such appraisals include land at its current market value and buildings and equipment at cost of replacement new less depreciation based upon such costs and the age and present condition of each unit." Bell, *Auditing*, p. 225; see also pp. 226-227.

² With reference to situations of this kind, Professor Roy B. Kester states as follows: "It may sometimes be desired to base an issue of bonds on real estate—land and buildings—which is being carried at an old cost figure as of many years ago but which has a greatly appreciated and available market value at the present time. Prudent financial considerations would require an independent appraisal to determine the amount of the bond issue. Upon the assumption that the issue is for a larger amount than the original cost of the security, a peculiar situation arises. In showing the transaction on the books and balance sheet, not only would no margin of security appear, but even an insufficiency of security so long as the original value of the security is carried. Here it would undoubtedly be wise to bring the appraised value of the security on the books, offsetting the appreciation in value by a suitably named surplus or reserve account, such as 'Reserve for Land Value Increment' or 'Appreciated Land Value Surplus.' Another method and perhaps a better one where possible of application is to reorganize the concern by a sale of the old to a new company and so capitalize the increment in value of the old company's assets." (See *Accounting Theory and Practice*, Vol. II, p. 305.)

Defend your position if you believe the real estate should have been valued similarly in the two cases.³

PROBLEM 43

BOWMAN REAL ESTATE COMPANY

Audit and Analysis of Real Estate Investments

The Bowman Real Estate Company, a corporation organized under the laws of the State of California, was located in Pasadena, Calif. The company acted as broker in the sale and purchase of real estate, and also operated as a dealer in city and country real estate. In the case of properties owned it was customary to carry a separate ledger account for each property, and to a certain extent separate operating accounts for the various properties were also kept.

In the audit of the accounts for the fiscal year ending December 31, 1928, the auditor was presented with a trial balance of the general ledger in which one of the items was:

Solano County Properties \$13,513.10

This was a debit balance, and represented a caption which was not included in the auditor's working papers for the previous year's audit. Accordingly, the auditor proceeded as early in the audit as convenient to determine the nature of this item.

Investigation revealed that the Solano County properties were purchased in April, 1928; they were represented by three separate pieces of land, aggregating 1,022 acres, more or less. The entire acreage was purchased as a single unit; no price quotation was made by the acre, or by the tract. The purchase price was \$67,500; the Bowman Real Estate Company paid \$30,000 in cash, assumed a \$10,000 mortgage on one 322-acre tract, and borrowed \$27,500 on the remaining two tracts. In verification

³ Sir Arthur Lowes Dickinson states, in this connection, that "there are well-known cases in which by far the greater part of the ultimate profits of a corporation over a long series of years has been due not to the results of its activities but to the large unearned increment on its capital assets. This condition must be recognized and is frequently met by means of careful appraisals of all properties, the resulting increase (or possibly decrease) being taken up as a special credit or debit to Profit and Loss account (or Surplus) and shown as entirely distinct from the operating results." *Accounting Practice and Procedure*, p. 81. See also Montgomery, *Auditing Theory and Practice*, 4th rev. ed., top p. 201.

of the above, the auditor examined resolutions in the minutes of the board of directors, contracts for the purchase of the properties, deeds properly recorded, policies of title insurance, canceled checks and cash book entries, and obtained confirmations from the mortgagees regarding the outstanding indebtedness.

In addition to the above purchase price, one of the tracts of land purchased had been used as a duck-shooting club and it was a part of the agreement that the purchaser should buy the existing memberships of the club at \$625 apiece. There were twenty of these memberships, which were purchased for the total sum of \$12,500; this brought the total cost of acquiring the properties up to \$80,000. Certain improvements, additional dredging, and so forth was then done, the total cost being \$3,513.10. As verification of the membership purchases, the auditor examined the certificates purchased, the canceled checks, and the cash book entries; the contract for the purchase of these certificates had already been examined. Vouchers were examined for the dredging and other improvements made.

Early in July, a contract was entered into with the Southern Pacific Company to sell to that company a right of way diagonally across one of the properties acquired; the acreage so sold amounted to approximately 43 acres, and the purchase price paid was \$40,000. The amount was paid in cash and out of this sum the Bowman Real Estate Company paid off the mortgage for \$27,500 set up when the properties were acquired. In verification of these transactions, the contract with the railroad company was examined, the receipt and disbursement of cash was traced into the cash book, and the canceled check, paid mortgage note, and release of mortgage were examined.

In view of the small acreage sold as compared with the total acreage of the tract, it appeared obvious that some element of profit entered into this transaction. The estimated selling price of the several tracts comprising the "Solano County properties" was roughly as follows:

Right of way sold to Southern Pacific Company	\$ 40,000.00
Tract No. 1 - Duck club and memberships	35,000.00
Tract No. 2 - Lincoln ranch	45,000.00
Tract No. 3 - Huntington ranch	30,000.00
Total estimated selling price	<u>\$150,000.00</u>

On the basis of apportioning the cost to the several tracts in the ratio of the selling price of each to the total selling price of the whole, the cost of the right of way would be $\frac{4}{15}$ of \$83,513.10, or \$22,270.16; on this basis there was a profit on the sale amounting to \$17,729.84, less any expenses of selling the tract. However, the company maintained that there was no practical way of determining the cost of the various tracts, and that the total amount received should be credited to the cost of the whole; profits, if any, will be considered as arising at such time as the proceeds from sales exceed the total cost of the properties, and then only to the extent of such excess. The audit revealed that the entire amount received from the sale of the right of way had been credited to the cost of the Solano County properties.

During November, 1928, the tract which had previously been used as a shooting club was sold to the Silver King Gun Club for \$30,000; this was known as tract No. 1, and the company had previously estimated it as worth \$35,000. On the above apportioned basis, this tract would have cost approximately \$19,500; however, it was this tract which had the \$10,000 mortgage on it, and it had cost \$12,500 to acquire the memberships, so that the company maintained that at least \$22,500 must be assigned to this tract as cost. Again, the entire amount had been credited to the cost of acquiring the whole tract; the two credits aggregating \$70,000 left the balance in the account shown in the general ledger trial balance. The Silver King Gun Club assumed the \$10,000 mortgage, and paid the balance of the purchase price in cash; the sale and the receipt of the cash were verified as previously described when the 43-acre tract was sold for the right of way. These two sales disposed of 365 acres, more or less, leaving 657 acres, more or less, as the property of the company.

Discuss briefly the audit of this account, and state whether or not the auditor should pass the "Solano County Properties" account as it was at December 31, 1928? If a profit should be taken up, how would you determine its amount? How would you state the asset in the company's balance sheet to be certified? Give reasons for all answers.

PROBLEM 44

THE JOHNSTON MANUFACTURING COMPANY

Audit of Automobile Delivery Trucks Account

You have been retained to audit the books and accounts of The Johnston Manufacturing Company for the fiscal year ended January 31, 1929; you are now engaged upon the audit of the Automobile Delivery Trucks account, and the related Reserve for Depreciation of Automobile Delivery Trucks account. The general ledger trial balance shows a debit balance for the asset account of \$16,016.76, and a credit balance for the reserve account of \$7,785.71. An analysis of the account gives the following information:

<u>Item</u>	<u>Date Bought</u>	<u>Cost</u>	<u>Credits</u>	<u>Depreciation to 1/31/28</u>
Mack truck	6/17/28	\$ 1,501.52		None
Kleiber one-ton truck	8/31/28	1,525.00		None
Chevrolet	8/ 3/26	810.95		\$ 304.11
Chevrolet	8/ 3/26	810.95		304.11
Chevrolet	2/27/25	773.25	\$200.00	563.82
Kleiber 2½-ton truck	8/20/25	3,657.93		2,286.20
Kleiber 2-ton truck	2/ 7/25	2,338.53		1,753.89
Moreland truck	9/29/26	2,360.00		786.67
Ford truck	3/ 1/25	484.14	100.00	353.03
Ford truck	3/ 1/25	453.24	100.00	330.49
Ford truck	9/ 6/25	566.54	125.00	342.28
Trailmobile - 5-ton	9/ 3/25	1,259.71		761.11
Totals		<u>\$16,541.76</u>	<u>\$525.00</u>	<u>\$7,785.71</u>

No provision has been made for depreciation for the fiscal year under review, it being the custom of the company to have the auditor make the annual computation for depreciation. All trucks are depreciated at the rate of 25% per annum; it has been the custom in the past to make the computation on the basis of whole months only (that is, if the truck is purchased before the middle of the month a full month's depreciation is counted; otherwise no depreciation is computed for that month).

The three Ford trucks were turned in as part payment on the Mack truck purchased June 17, 1928; a total allowance of \$325 was made for the three machines. The Chevrolet truck was turned in for \$200 on the purchase of the Kleiber one-ton truck

on August 31, 1928; the balance of the purchase price in each case was paid in cash.

Explain in detail what you would do to audit the above accounts; prepare all journal entries necessary to adjust the accounts as of January 31, 1929, and state at what amounts both of the accounts will appear in the audited balance sheet as of that date. Comment upon the client's methods of accounting for the trucks, and for the provision for depreciation thereon.

PROBLEM 45

THE MENLO MINING COMPANY

Verification of Appreciation in Mining Lands

The Menlo Mining Company owns undeveloped mining lands in Mexico, on which it had expended up to June 30, 1928 as actual out-of-pocket expenses the amount of \$86,340.90. It was then decided by the board of directors to have a geological survey made of the properties, and accordingly, a commercial geologist from New York City was employed to conduct the survey. The geologist visited the properties in Mexico, and submitted his report the latter part of August; in this report he estimated that there were minerals underground of an approximate value of \$5,300,000. At the September meeting of the board of directors, the report of the geologist was considered, and it was resolved that the valuation of \$5,300,000 reported by the geologist "be and hereby is declared the value" of the mining lands; the resolution also provided that the comptroller of the company should be instructed to take up this new value, and to adjust the Mexican Mining Lands account accordingly in the books.

Upon taking up the audit of the accounts for the fiscal year ending September 30, 1928, the auditor found in the general ledger a debit to the Mexican Mining Lands account of \$5,213,659.10.

What verification should be made of the account? Under what caption, and at what amount, should the mining lands appear in the certified balance sheet? Give reasons.¹

¹ See Hatfield, *Accounting*, pp. 196-198.

PROBLEM 46

THE ALPHA MAIN COMPANY

Valuation of a Leasehold

The Alpha Main Company, one of the largest department stores in Brooklyn, New York, leases one of the buildings which it occupies from the president of the company, who, in turn, in 1916 leased it from the owner for a period of 99 years. The terms of the lease between the president and the owner of the property were as follows:

The president of the Alpha Main Company was to pay an annual rental of \$15,000, said rent being payable \$1,250 monthly in advance. It was also agreed that either upon the death of the owner of the property, or in any event not later than December 31, 1936, the president of the Alpha Main Company had the option to purchase the property for \$150,000 cash.

In 1918, the president sold the leasehold to the Alpha Main Company, the consideration being the assumption by the company of the annual payment of \$15,000 to the owner of the property, plus a net yearly payment to him of \$3,000 for the remaining term of the lease—making a gross annual payment by the Alpha Main Company of \$18,000 for the lease.

Early in 1926 the Alpha Main Company desired to sell to the public \$200,000 7% cumulative preferred stock, and it requested its public auditor to prepare and certify a balance sheet which would give effect to this proposed financing. Among other things, the directors desired to include in the accounts any value which might exist for this lease. Accordingly, the directors had the property appraised by responsible real estate appraisers who valued it at a sound value of \$275,000; the appraisers also stated, in their opinion, a conservative rental value for the property was 10% of this amount, or \$27,500. The directors believed that this appraised value of the property approximated the value of the lease, and they requested the auditor to set up this amount in the accounts as "Leasehold."

The auditor agreed that the leasehold undoubtedly had great value, but he maintained that the value of the lease had no neces-

sary relation to the present sound value of the property. He pointed out that while the Alpha Main Company could purchase the property if it willed to do so, it had not actually bought the property, and so far no resolution had been recorded in the minutes of the board of directors stating the company's intention to take advantage of the option to purchase. He also stated that even if the directors had resolved to buy the property, and therefore desired to have the amount set up in the accounts at the present sound value of \$275,000, it would be necessary to set up also the liability of \$150,000 which the company was bound to pay to acquire the property. The difference, \$125,000, he suggested might be credited to a capital surplus account. The directors did not desire at this time to bind the company to exercise its option, and they did not wish to have reflected in the accounts any liability which might be incurred thereby.

The auditor then suggested that, inasmuch as the real estate appraisers had given it as their opinion that the rental value of the property at present was conservatively \$27,500 per annum, a valuation for the leasehold be determined on the basis of the property's capitalized excess rental value. Since the company paid an annual rental of only \$18,000, there was an excess rental value of \$9,500; an annuity of \$9,500 for 89 years was obviously of very great value.

The following computations were then made by the auditor, and the values thus determined presented to the directors:

P.W. annuity \$1 at 4%	for 89 years =	\$24.23797
P.W. annuity \$1 at 3½%	for 89 years =	\$27.23409
P.W. annuity \$1 at 3%	for 89 years =	\$30.93248

Therefore an annuity of \$9,500 for 89 years		
at 4%	would be worth at present	\$230,260.72
at 3½%	would be worth at present	\$258,723.86
at 3%	would be worth at present	\$293,858.56

Some of the directors believed that any rate below 4% was not a fair basis of capitalization, and that in any case not more than \$230,000 should be set up in the books as the value of the leasehold. Other directors believed that the figures which the auditor had arrived at were so nearly in agreement with the appraised sound value of the property that that amount should be

placed on the books as the value of the leasehold; one director maintained that inasmuch as life insurance companies frequently computed annuities on a 3% basis they should record the value of the leasehold as \$293,000.

After some further discussion of the matter, it was resolved by the board of directors that the value of the leasehold "be, and hereby is declared to be, \$230,000," and that the company's accountant "be, and hereby is, instructed to take up in the accounts such value." After consultation with the auditor the company's accountant prepared a journal voucher debiting "Leasehold" and crediting "Capital Surplus" for \$230,000.

Criticize constructively the basis of valuing the leasehold, and the propriety of taking up such value in the accounts of the company. How should the item appear in the balance sheet prepared to give effect to the proposed financing?¹

PROBLEM 47

CHARLOTTE MILLS, INCORPORATED—PART VIII

Verification of Deferred Charges

The deferred charges of the company as per its general and private ledgers trial balances at June 30, 1924, were as follows:¹

DEFERRED CHARGES

P.L. 17	Organization Expenses	\$127,650.42
P.L. 19	Discount and Commission on Bonds	270,994.08
G.L.	Interest Prepaid	44,270.84
G.L.	Insurance Prepaid	32,527.20
G.L.	Container Account	1,564.00

The verification of interest prepaid would ordinarily be made when the Notes Payable account is analyzed, and will be done in this way here. Likewise, Discount and Commission on Bonds will be verified along with the liability for First Mortgage Bonds.

¹ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 214-216; Bell, *Auditing*, p. 247; Kilduff, *Auditing and Accounting Handbook*, pp. 133-134; Castenholz, *Auditing Procedure*, p. 88; Finney, *Principles of Accounting*, Vol. II, Ch. 42, pp. 3-6.

¹ Similar items appeared in the final balance sheet as of June 30, 1923 (Part I of the Problem), the total amount being \$468,706.90. The balances shown by the private ledger trial balance as of June 30, 1924, are unchanged from the balance sheet figures of a year earlier.

The schedules resulting from the verification of these accounts will then be attached or cross-indexed to the deferred charges summary schedule. The analyses of the other accounts follow:

Organization Expenses

There has been no change in this account during the year under audit, nor, in fact, since the inception of the account. Your working papers for the fiscal period ended June 30, 1917 show the following analysis of the account as originally set up, and as at present recorded in the books of account:

CHARLOTTE MILLS, INCORPORATED			D ¹
P.L. 17	ORGANIZATION EXPENSES		June 30, 1917
<u>Date</u>	<u>Jo. Vo. No.</u>	<u>Description of Charge</u>	<u>Dr.</u>
July 1, 1916	27	Legal fees paid as follows: Smith & Jones - Preliminary study of legal phases of consolidation \$ 5,000.00 Smith & Jones - Services re incorporation, examination of titles of real property taken over from other companies, and miscellaneous services. 18,750.00	\$ 23,750.00
July 1, 1916	28	Commissioner of Corporations, Mass. filing fee	25.00
July 1, 1916	31	American Bank Note Co. - Cost of engraving stock certificates and bonds	3,500.00
July 1, 1916	39	Bonus paid A. A. White, president, Xwise Spinning Co., for services in securing consent of stockholders of Spinning Co. to sell its properties to this Charlotte Mills, Incorporated	25,000.00
July 5, 1916	57	Day & Night, attorneys - For opinion on legality of bond issue	5,000.00
July 20, 1916	103	Jones & Konnor - Investment Bankers - Expense of disposing of preferred and common stocks which were not issued for property or services	12,042.09
Dec. 31, 1916	954	Interest for 2 months, July and August, 1916, on \$5,000,000.00 7% bonds. This amount was charged to this account because the plants were in such condition of construction or remodelling that production was far below normal; the Directors of Charlotte Mills, Incorporated, voted at their regular meeting of Dec. 14, 1916 to charge this interest to organization expense on the theory that it was interest expense during the period before beginning actual operations	58,333.33
Total			\$127,650.42
			To D

Journal vouchers and invoices for all above amounts were examined.
Payments were traced to the Cash Book.
F. J. K.

The comptroller requests that in making your report this year to the board of directors, you express an opinion as to the desirability of amortizing this balance over the next five years.²

Insurance Prepaid

All insurance is placed through one insurance broker; he furnished you with a letter certifying that the amount of insurance premium prepaid at June 30, 1924 on policies held by him in safekeeping was \$28,653.20. The letter was as follows:

JOHN ANTEA & COMPANY
Insurance Brokers

60 State Street,
Boston, Massachusetts,
August 26, 1924.

Mr. J. M. Goode, Auditor,
First National Bank Building,
Boston, Massachusetts.

Charlotte Mills, Incorporated, Ins. Prem.

Dear Sir:

In accordance with your request dated August 21, 1924, and approved by Charlotte Mills, Incorporated, we are furnishing you the following information concerning the value of that company's unexpired insurance premiums on policies in our possession at June 30, 1924:

Unexpired premiums:

Fire	\$18,386.66
Liability	9,426.04
Miscellaneous	840.50
Total	<u>\$28,653.20</u>

A list of the policies in our possession is enclosed herewith.

Yours very truly,
(Signed) John Antea & Co.

Charlotte Mills, Incorporated also keeps an insurance register (an auxiliary record), which shows by sections the total insurance carried on various classes of assets. The book has the following columns:

² See Montgomery, *Auditing Theory and Practice*, 3rd ed., Vol. I, p. 576; also 4th rev. ed., top p. 621. For a somewhat different view see Bell, *Auditing*, pp. 255-256.

Number of policy
 Name of insurance company
 Date of policy
 Expiration date
 Amount of coverage (shown by classes of assets)
 Amount of premium

Columns are also provided for each month of the year, in which are entered the portion of the premium expiring monthly. The totals of these columns are the basis for the monthly charge to the manufacturing expense accounts and the credit to Insurance Prepaid.

When insurance is purchased, the financial entry is to debit Insurance Prepaid and to credit Cash, or Accounts Payable. The policy is then entered in the insurance register under the asset classification upon which the coverage has been placed.

All policies are on file with the insurance broker except those held by the trustee for the outstanding first mortgage bonds; the existence of these policies was verified by the following letter from the trustee:

FIRST TRUST COMPANY

Boston, Massachusetts,
 August 20, 1924.

Mr. J. M. Goode, Auditor,
 First National Bank Building,
 Boston, Massachusetts.

Dear Sir:

In accordance with the request of the Treasurer of Charlotte Mills, Incorporated, we desire to state that the amount of insurance coverage on property of that company subject to the mortgage indenture securing its First Mortgage bonds was as follows at June 30, 1924:

Fire	\$7,020,000.00
Boiler	85,000.00
Total coverage.	<u>\$7,105,000.00</u>

These policies were renewed on July 15 for one year, the amount of coverage being maintained at the above figure.

A list is attached of the policies which are in our possession.

Yours very truly,
 (Signed) FIRST TRUST COMPANY
 by James Noah, Trust Officer

The lists of policies held by the broker and trustee were checked to the insurance register; all premiums paid during the current year were traced to properly approved vouchers, and to the cash book. From the insurance register, the following summary was prepared—the insurance broker's letter was accepted as sufficient verification of the prepaid premiums on policies in his possession, while the company's computations of the prepaid premiums on policies with the trustee were tested:

INSURANCE PREMIUMS PREPAID

Description of Property	Coverage	Period Prepaid	Rate per \$100	Amount Prepaid
<u>FIRE INSURANCE</u>				
Mill Properties	4,000,000	15 d's	90¢	\$ 1,500.00
Machinery (covered by mtge.) . . .	3,020,000	15 d's	90¢	1,132.50
Other machinery, etc.	10,000,000	50 d's	90¢	12,500.00
Merchandise	4,000,000	59 d's	90¢	5,886.66
				\$21,019.16
<u>LIABILITY INSURANCE</u>				
Miscellaneous		2 mos.	Various	9,426.04
<u>BOILER INSURANCE</u>				
Miscellaneous	85,000	Various	4.50	1,241.50
<u>MISCELLANEOUS</u>				840.50
TOTAL PREPAID (per ledger)				<u>\$32,527.20</u>

Container Account

Containers are used for transporting cloth between the mills and the bleacheries. They last from six to eight months; the practice has been to set up their cost as a deferred charge and to revalue them at closing dates. Adjustments are then made in the account as may be necessary; the adjusted account at June 30, 1924, per the ledger was as follows:

CONTAINER ACCOUNT

1923				1924			
July 1	Balance . .		\$1,220.00	June 30	J. V. 1409	J381	\$4,782.70
Sept. 19	J. V. 857	J139	3,526.70		Balance . .		1,564.00
1924							
Feb. 17	J. V. 1012	J290	1,600.00				
			\$6,346.70				\$6,346.70
1924							
July 1	Balance . .		\$1,564.00				

The journal vouchers were secured and the numbers of the invoices for the purchases of September 19 and February 17 were taken from them. These invoices were then obtained from the filing department and were examined for approvals, for receipt of goods, for payment, etc. The inventory of containers at June 30, which was valued by the superintendent's office at its estimated present worth, was next examined; the credit of \$4,782.70 was the difference between the total debits to the account and the amount of this inventory. The journal voucher for this credit showed a counterbalancing debit to Manufacturing Expense.

Comment upon the sufficiency of the above verification; are you satisfied with it? If not, what additional examination of the accounts would you make? Prepare for your working papers a summary schedule, and such other schedules as you deem necessary or desirable.³

³ See Bell, *Auditing*, pp. 248-58; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 140-142, 613-625; Jackson, *Audit Working Papers*, pp. 106-112 and Appendix A; *Journal of Accountancy*, Vol. XVII, No. 5 (May, 1914), pp. 384-388.

Part VI—Verification of Liabilities, Reserves, and Proprietorship

PROBLEM 48

ARMSTRONG MANUFACTURING COMPANY

Verification of Notes Payable

The Armstrong Manufacturing Company was located in Des Moines, Iowa; it produced and distributed agricultural machinery and equipment, doing a business of approximately eight million dollars annually. The total assets of the company were nearly \$7,000,000; the capital stock and surplus totaled slightly in excess of \$4,000,000, and the current liabilities were shown by the books as slightly more than \$1,000,000. There was a mortgage of \$1,000,000 on the properties, and sundry reserves aggregated another \$1,000,000. The company's books and accounts were audited annually by Messrs. Quick and Sure, Certified Public Accountants, Hippee-Polk Building, Des Moines; early in February, 1929, this firm took up the audit of the company's accounts for the fiscal year ended December 31, 1928. According to the trial balance of the general ledger, the notes payable outstanding at the close of the fiscal period totaled \$722,200.

The capital stock of the Armstrong Manufacturing Company was very closely held, and the senior assistant in charge of the audit knew from previous experience that a number of these notes represented the funds of relatives of the founder of the company; the company, as a matter of accommodation, paid a higher rate of interest on these notes than the lenders could obtain with safety elsewhere.

An analysis of the notes payable was made, showing the notes outstanding at December 31, 1927, all notes issued or paid during 1928, and the notes outstanding at the end of 1928. In the case of all notes issued the cash received was traced into the cash

ARMSTRONG MANU

NOTES PAYABLE,

Date	PAYEE	Due	Interest rate	Balance, Dec. 31, 1927	Notes Issued 1928
Jan. 11, 1924	Helen W. Armstrong	Demand	8 %	\$ 20,000.00	—
Feb. 2, 1924	" " "	"	8 %	12,000.00	—
Apr. 28, 1925	George E. Armstrong, Jr.	"	7 %	34,000.00	—
Aug. 13, 1925	Flora Armstrong Black	"	6 %	4,200.00	—
Feb. 11, 1926	" " "	"	6 %	17,800.00	—
Mch. 11, 1926	Estate of George E. Armstrong	"	6 %	160,000.00	—
Jan. 20, 1927	Garrett & Bridges, Inc.	1/20/28	6 %	100,000.00	—
Mch. 12, 1927	Victor H. Armstrong	3/12/30	8 %	9,600.00	—
April 1, 1927	Armstrong Distributors, Inc.	Demand	6 %	9,900.00	—
Oct. 1, 1927	" " "	"	6 %	33,000.00	—
" 1, 1927	" " "	"	6 %	3,900.00	—
Feb. 7, 1928	First National Bank	8/ 7/28	7 %	—	\$ 5,000.00
" " "	" " "	"	6 %	—	10,000.00
Feb. 29, 1928	Grant National Bank, Chicago	Demand	5 %	—	800,000.00
" " "	" " "	"	5 %	—	96,000.00
Mch. 1, 1928	First National Bank, Chicago	30 days	5 %	—	280,000.00
" 23, 1928	" " " "	90 "	5 %	—	120,000.00
June 6, 1928	" " " "	90 "	5 %	—	200,000.00
" 20, 1928	Grant " " "	9/18/28	5½ %	—	1,000,000.00
" 20, 1928	Central National Bank	1 yr.	6 %	—	18,000.00
Sept. 3, 1928	Grant National Bank, Chicago	12/ 2/28	4 %	—	482,938.00
Dec. 11, 1928	First National Bank, "	4/11/29	5½ %	—	100,000.00
" 18, 1928	" " "	4/18/29	5½ %	—	300,000.00
Note: Chicago notes secured by capital stock of Armstrong Manufacturing Company.				\$404,200.00 ✓	\$3,411,938.00 ✓

book and bank, and in the case of all notes paid the canceled notes were examined and the payments were traced into the cash book.¹ All notes outstanding at the close of the fiscal period were confirmed by correspondence with the holders.

The interest account was thoroughly analyzed, and it was found that all interest, shown by that account as paid on notes, related to the notes recorded in the books. Furthermore, the requests for confirmation of cash balances sent to all banks with which the company did business during 1928 revealed no notes outstanding other than those shown by the books of account. It

¹ In this part of the audit it is only necessary to trace the notes into the cash book; the cash verification will determine the accuracy of the cash records. The student should remember that no part of the audit is complete in itself; it is only when the work is completed and the various parts brought together as a whole that the auditor can feel satisfied that a comprehensive audit has been made. The scheme of "checks and balances" applies to the audit in somewhat the same way that it does to the sufficiency of the method of accounting itself.

FACTURING COMPANY

DECEMBER 31, 1928

Notes Paid 1928	Balance, Dec. 31, 1928	Verified		INTEREST			
		Con- firmed	Note seen	PAID		Accrued	Total
				To	Amount		
—	\$ 20,000.00	✓		Dec. 11, 1928	\$ 1,511.12	\$ 88.88	\$ 1,600.00
—	12,000.00	✓		" 2, 1928	882.68	77.32	960.00
—	34,000.00	✓		" 28, 1928	2,360.16	19.84	2,380.00
—	4,200.00	✓		" 13, 1928	239.40	12.60	252.00
—	17,600.00	✓		Jan. 1, 1929	1,056.00	—	1,056.00
—	160,000.00	✓		Dec. 15, 1928	9,173.33	426.67	9,600.00
8/1 \$ 100,000.00	—	✓	✓	—	3,716.68	—	3,716.68
—	9,600.00	✓		Jan. 12, 1929	791.46	Prepaid 25.60	765.86
—	9,900.00	✓		Jan. 1, 1929	594.00	—	594.00
—	33,000.00	✓		—	1,980.00	—	1,980.00
—	3,900.00	✓		"	234.00	—	234.00
8/1 5,000.00	—	✓	✓	—	103.34	—	103.34
8/1 10,000.00	—	✓	✓	—	60.28	—	60.28
3/14 800,000.00	—	✓	✓	—	1,444.44	—	1,444.44
3/14 96,000.00	—	✓	✓	—	186.60	—	186.60
3/12 280,000.00	—	✓	✓	—	427.78	—	427.78
5/2 120,000.00	—	✓	✓	—	666.66	—	666.66
8/1 200,000.00	—	✓	✓	—	1,555.56	—	1,555.56
8/1 1,000,000.00	—	✓	✓	—	6,579.46	—	6,579.46
—	18,000.00	✓		None paid	—	570.00	570.00
{ 9/3 200,000.00	—	✓	✓	—	965.36	—	965.36
{ 10/1 282,938.00	—	✓		—	—	305.56	305.56
—	100,000.00	✓		—	—	595.80	595.80
—	300,000.00	✓		—	—	—	—
\$3,093,938.00	\$722,200.00				\$34,528.31	\$2,071.07	\$36,599.38
✓	✓				✓	Prepaid 25.60	✓
	To B/S					Accr. \$2,096.67	To P/L
						✓ To B/S	

had been previously determined that the company required the signatures of two officials of the company on all notes; all canceled notes examined had been signed by the treasurer, and either by the secretary or by the auditor of the company. It was specifically seen that all such notes had been definitely canceled.

In obtaining confirmations from the holders of the outstanding notes as at December 31, 1928, the auditor requested not only that the amounts of the notes be stated, but also that the date of the notes, the due dates, the rates of interest, the date to which the interest was paid, and the securities held as collateral be given. These confirmations served as supporting schedules to the summary of notes payable prepared by the assistant in charge of the audit; the summary was prepared as shown above.

Discuss the verification of notes payable as outlined in the preceding pages. Should any additional verification have been made? If so, what? If not, why not? Give reasons for all answers.²

PROBLEM 49

THE CALIFORNIA-PACIFIC COMPANY

Audit of Accounts Payable

During the audit of the accounts of The California-Pacific Company,¹ one assistant was assigned the task of verifying the item of Accounts Payable. By reference to the general ledger trial balance, the assistant found that the balance of this account as shown by the general ledger was \$317,953.46. It was also ascertained that there was no accounts payable ledger; the detail supporting the general ledger balance consisted of the "open" or unpaid items in the voucher register. The company had never kept a subsidiary ledger for the accounts of creditors.

Since the audit was for the fiscal year ended December 31, 1927, the auditor obtained the voucher register, and, beginning with the last entry for the period under audit, prepared a list—by working backward from December 31—on the adding-machine of all open balances. From the previous year's working papers, the assistant knew that the sum of the open balances in the voucher register at December 31, 1926 was \$703.08 less than the balance shown in the general ledger for Accounts Payable; however, the president of the company had requested the auditor not to look for this difference, stating that it would be checked out by the company's bookkeeping department before December 31, 1927. The difference of \$703.08 was made up of balances of several years, as follows:

Differences prior to December 31, 1924	\$207.93
During 1925	6.68
During 1926	488.47
Total differences	<u>\$703.08</u>

² See Jackson, *Audit Working Papers*, pp. 121-123; also, with reference to the confirmation of liabilities when cash confirmations are obtained, Appendix B, Exhibit 13.

¹ See Problems 24 and 25, pp. 128-141, of this volume.

Accordingly, the auditor was not greatly surprised when he found that the total of the open balances in the voucher register was \$799.53 less than the general ledger balance for Accounts Payable. Upon inquiry from the head bookkeeper, it was ascertained that the differences existing at December 31, 1926 had not been adjusted during 1927; the president of the company again stated that he did not wish the auditors to take time to check out these differences. The auditor did, however, carefully check his computations again to the voucher register to satisfy himself that he had not missed any items in the preparation of the adding-machine list; it was then recommended to the president of the company, inasmuch as none of these amounts had later been covered by invoices from creditors, that the entire \$799.53 be written off as of December 31, 1927. The president agreed to this, and assured the auditor that beginning with January, 1928 the open items in the voucher register would be balanced each month with the general ledger control account; the auditor then prepared the following adjusting journal entry, which the company took up in its books:

Accounts Payable (Account No. 142)	\$799.53	
To Mdse. Loss (Account No. D-13)		\$799.53
To adjust general ledger account No. 142 to agree with the Vouchers Payable record, covering differences of this and prior years. ²		

When the verification of the inventory was being made, the assistant assigned to that work had carefully examined the receiving records to see that all goods which had been received on the final days of the fiscal period had been included in the inventories, and had been taken up in the books of account. Similarly, it was found that goods in transit had been accounted for among the liabilities. The expense accounts were then scrutinized for the month of December; the amounts were compared with those for other months of the year, and with December, 1926, and the

² Account No. D-13 records all shrinkages in physical inventories, as compared with the book inventory figures, or losses occurring from merchandise becoming unsalable. Inasmuch as Merchandise Purchases account was debited when Accounts Payable was credited for the above amount, it is obvious that Merchandise Loss account was charged for the discrepancy between the physical and book inventories; hence the credit to the latter account at this time. Account No. D-13 is closed into Trading account at the close of each year.

auditor was satisfied that no appreciable item of expense had been omitted from the accounts.

Creditors' statements were also examined, and were found to be in agreement with the amounts as shown by the books as owing to the respective creditors. Finally, all January, 1928 vouchers were examined; 29 items, aggregating \$791.72, were found which were applicable to the year 1927. However, since the company had already prepared the bulk of its operating reports and statements, it did not desire to have these items included in the 1927 accounts; accordingly, the auditor decided to omit them also in preparing the company's balance sheet for certification—in a balance sheet with two million dollars of assets such items were wholly insignificant. The schedule on which the items were listed was, however, included in the working papers.

The matter of liabilities had been kept constantly in mind during the perusal of the corporate minutes, but nothing had been found which had not already been provided for in the accounts. Inquiry was made regarding purchase contracts, but from the nature of the company's activities, the only contracts in force were with manufacturers for the sale of certain commodities, but prices were determined by the current market. No merchandise was held on consignment, and no liability was found to exist because of account sales. Accruals on account of taxes, interest, wages, and so forth were looked into thoroughly, with the following results:

The tax receipts for the year 1927 were obtained, and were found to agree with the debit to the Taxes account in the general ledger. This amount, \$17,643.80, represented the total property taxes, plus the corporate state taxes. The tax year in California is from July 1 to June 30; the company followed the practice each year of including as an expense and as an accrued liability the portion of the real estate taxes for the second one-half of the tax year, namely, January 1 to June 30. This amounted to \$3,645.72, and was already set up in the accounts.

The company had shown a taxable loss for the fiscal year 1926, this loss more than offsetting the taxable income for the year 1927. Accordingly, no federal income tax had been paid during 1927, and there was no liability on account of federal taxes to be taken up in the accounts at December 31, 1927. The company's returns had

been audited by the Income Tax Unit through the taxable year 1925, and the auditor was satisfied that no additional tax liability existed.

In connection with the verification of notes payable, the interest expense account had been analyzed, and the accrued interest payable verified. The amount was found to be \$935.74; this had already been taken up in the accounts by the company itself.

The company's payroll week was from Friday morning to Thursday night; this only applied to the truckers and delivery men, and to the workers in the stock and shipping departments. All employees in the office were paid twice monthly, on the 15th and closing days of the month. The year ended on Saturday; accordingly there were wages accrued for a day and one-half. The payroll for the week ending January 5, 1928 was \$2,174.98; three-elevenths of this would be approximately \$600. The company had taken up as a liability \$617.43; this was slightly more than three-elevenths of the total, but the payroll clerk produced the payroll showing that several of the employees had worked all day on Saturday, December 31, taking the physical inventory. On this basis the assistant accepted the amount as satisfactory for the purposes of the audit.

No other liabilities, actual or contingent, being found, the assistant prepared the following summary of accounts payable:

ACCOUNTS PAYABLE, DECEMBER 31, 1927

Balance, per General Ledger, December 31, 1927	\$317,953.46
Deduct: To adjust General Ledger account to agree with Voucher Payable Record - J. E. No. 1	799.53
Adjusted Balance, December 31, 1927	<u>\$317,153.93</u>
Add:	
Accruals - Property Taxes	\$3,645.72
Interest Payable	935.74
Payroll	<u>617.43</u>
Credit balances on Accounts Receivable	2,328.58
Total Accounts Payable, December 31, 1927, per Balance Sheet . . .	<u>\$324,681.40</u>

Upon the completion of the entire audit, the last thing the auditor did, after he had exercised the greatest care in the verification of both the assets and liabilities of the company, was to obtain the following certificate of liabilities; it served as additional proof, and as special precaution, against the probability of unbooked actual or contingent liabilities of which the auditor would have no opportunity to know:

THE CALIFORNIA-PACIFIC COMPANY
San Francisco, California

February 2, 1928.

Messrs. Rembrandt, Wellington & Co.,
Standard Oil Building,
San Francisco, Calif.

Certificate of Liabilities

Dear Sirs:

We hereby certify that to the best of our knowledge and belief all liabilities of The California-Pacific Company as of December 31, 1927, in respect to merchandise and supplies on hand, or in transit at December 31, and accrued liabilities for taxes, legal fees, interest, wages, etc., have been brought into the books as of that date.

We also certify that to the best of our knowledge and belief no liability, direct or contingent, exists in respect to lawsuits, contracts, or otherwise.

Yours very truly,
THE CALIFORNIA-PACIFIC COMPANY
per (*signed*) W. D. Morrow
Vice-Pres. & General Mgr.
per (*signed*) J. C. Jurisé
Asst. Treas. & Comptroller

Was the verification of the accounts payable of The California-Pacific Company, as set forth above, satisfactory for the purposes of a limited-test audit? If not, why not? Discuss.

PROBLEM 50

THE ILLINOIS JEWELRY COMPANY

Audit of Accounts Payable

The Illinois Jewelry Company, Chicago, Illinois, a manufacturer and distributor of high-grade novelty jewelry, requested you to audit its accounts for its fiscal year ended September 30, 1927, and to certify its balance sheet for presentation to stockholders and bankers. The total assets of the company were approximately \$4,000,000; you had already satisfied yourself that the system of internal accounting was reasonably satisfactory.

You took up, at the proper time, the verification of the com-

pany's accounts payable; there were three such accounts in the general ledger, as follows:

Accounts Payable – credit balance	\$137,850.00
Bracelet Accounts Payable – credit balance	107,380.00
Accounts Payable, Special Bonus – credit balance .	183,600.00

A separate analysis of each of these accounts gave you the facts set forth below:

(a) Accounts Payable, \$137,850

You were informed by the comptroller that this account recorded the regular trade accounts payable of the business, together with all existing liabilities for wages, salaries, taxes, interest, and the like. You obtained the company's trial balance of the subsidiary accounts payable ledger, proved the accuracy of the footings, and checked the items against the subsidiary ledger accounts. These you found in agreement. The subsidiary ledger showed aggregate credit balances of \$139,025 and aggregate debit balances of \$1,175. You had already examined the Accounts Receivable; you found credit balances in the customers' ledger amounting to \$1,420.

You also examined, before the audit was completed, all bills and invoices received since the close of the fiscal period; you found that during October and November, 1927, invoices amounting to \$3,125 and applicable to the year ended September 30, 1927, were taken up in the accounts. Of this amount, items aggregating \$1,813 were applicable to the expenses of the year under audit, and the other items represented merchandise in transit at September 30. So far as you could ascertain, no other liabilities of the period under audit were outstanding, such as merchandise in transit, legal and other expenses, and so forth.

Moreover, you scrutinized the individual accounts to satisfy yourself that the accounts payable all represented balances owed to regular creditors of the business, that is, that none of them were fictitious credits which had been made for the purpose of disbursing funds fraudulently; you also traced the debits to the controlling account to the original records and satisfied yourself not only that all items were genuine, but also that all disburse-

ments had been properly recorded. The only unusual item appearing among the accounts payable was one for \$2,250, payable to the president of the company; this you found was a special bonus owing the president on the previous period's earnings.

You obtained the usual liability certificate from proper officers of the company, certifying that all liabilities, actual or contingent, which were known to exist at September 30, 1927, had been fully provided for in the accounts; this certificate read as follows:

THE ILLINOIS JEWELRY COMPANY
Chicago, Illinois

November 11, 1927

Mr. Goode Student, C.P.A.,
231 South LaSalle Street,
Chicago, Illinois.

Dear Sir:

Certificate of Liabilities

We hereby certify that to the best of our knowledge and belief all liabilities relating to the fiscal period ended September 30, 1927, in respect to borrowed money, materials and supplies in transit at September 30, accrued liabilities for wages, salaries, taxes, interest, and the like, have been recorded in the books, or have been provided for as of that date.

We also certify that to the best of our knowledge and belief no liability, direct or contingent, exists in respect to lawsuits, contracts, or otherwise, except such as have been provided for in the accounts, or have been brought to the attention of the auditor.

Yours very truly,

(Signed) Robert A. Graham, Comptroller
Nathan O. Daggett, Secretary
Albert S. Swick, Auditor

(b) Bracelet Accounts Payable, \$107,380

You were informed by the company's general auditor that The Illinois Jewelry Company had a special arrangement with its dealers whereby any merchandise returned to the company was credited not to the dealers' regular accounts (that is, to the accounts receivable which were debited when the merchandise was purchased); it was credited, rather, to a "bracelet" account with the respective dealer, and the amount of the credit was applied not in payment of regular purchases, but only to the purchase of

certain special styles of bracelets manufactured by the company. Whenever a dealer bought a quantity of these bracelets his "bracelet" account was debited; this debit was an offset to any credits which had arisen from merchandise returned for any reason from regular purchases.

The "bracelet" accounts were found in the accounts receivable ledgers. The regular accounts receivable were kept on white paper, followed, for the respective dealers, by a "bracelet" account on buff paper (the bracelet account in nearly all cases had a credit balance). You ascertained that the bracelet accounts payable were in agreement with the controlling account, and you satisfied yourself that the monthly debits and credits to the Bracelet Accounts Payable controlling account were proper. To accomplish this you examined a large number of the duplicate credit memoranda issued to customers for merchandise returned for credit, and you made thorough tests of the receiving records to see that the goods for which the credit memoranda were issued had been actually received; further, you traced certain of the items to the permanent stock cards to be sure that the returned goods were again taken into the inventory at figures not in excess of cost.

The debits to the bracelet accounts were posted from a special sales book; this book was carefully scrutinized, and the monthly totals were checked to the general ledger controlling account. The shipping records were examined for the last three days of September and for the first three days of October to prove that all goods shipped before the close of the fiscal period had been charged in the books, and also that goods shipped after September 30 had not been included in the sales for the fiscal period under audit. Your examination satisfied you that the records and accounts were correct.

(c) Accounts Payable, Special Bonus, \$183,600

You further found that, in addition to the arrangement reflected by the "bracelet" accounts, the Illinois company made written contracts with all dealers,¹ in which it was agreed that if a dealer purchased a named amount of jewelry within a given

¹ The form of contract for the fiscal year ended September 30, 1927, was as follows:
This Agreement made this.....day of.....
1926 by and between THE ILLINOIS JEWELRY COMPANY, a corporation of the State of

fiscal period The Illinois Jewelry Company would give the dealer a bonus, this bonus to consist of an assorted selection of jewelry the value of which should equal an agreed percentage of his purchases.

A large number of these contracts were examined by you, and you found the provisions in the contracts as follows :

<u>Agreed minimum to be purchased by dealer</u>	<u>Agreed percentage to be donated by manufacturer</u>
\$ 1,000.00	10%
2,500.00	15%
5,000.00	20%
10,000.00 (and over)	25%

According to the contract, if the consumer bought less than the contract called for, the manufacturer owed him nothing; be-

Illinois, hereinafter called the COMPANY, and.....
of
hereinafter called the CONSUMER:

WITNESSETH, WHEREAS the COMPANY is a manufacturer and distributor of high-grade novelty jewelry and is willing to grant to large consumers of its jewelry, under certain conditions as to purchases of said jewelry, a Bonus upon the Company's jewelry purchased by the CONSUMER: and

WHEREAS, the CONSUMER desires to secure from the COMPANY the said Bonus on the terms and conditions hereinafter stated;

Now, THEREFORE, in consideration of the premises and the sum of One Dollar, each to the other in hand paid, receipt whereof is hereby acknowledged, and in further consideration of the covenants hereinafter contained, the parties hereto have agreed as follows:

1. The CONSUMER covenants and agrees to purchase from the COMPANY, or from WHOLESALE-SALERS handling the Company's products, jewelry to the total purchase price and amount of \$.....Dollars during the term of this agreement.

2. The CONSUMER covenants and agrees not to substitute products of another manufacturer for products of the Company when such products of the Company are called for by, or specified on orders from its customers.

3. The CONSUMER covenants and agrees not to substitute the cheaper grades of jewelry manufactured by the Company for its better grades when such better grades are called for by or specified on orders from its customers.

4. Upon the faithful carrying out by the CONSUMER of the aforesaid covenants, the COMPANY hereby covenants and agrees to give direct to the CONSUMER a Bonus on all such jewelry of its manufacture purchased and paid for by the consumer during the term of this agreement by delivering free of charge to the CONSUMER jewelry of the Company's manufacture, as specified by the CONSUMER of the value of \$.....Dollars. The value of the jewelry so delivered as said Bonus is to be computed at the Unit Prices of such jewelry published in the Company's price list current September 1, 1927.

5. It is mutually covenanted and agreed that as evidence of the purchase of said jewelry by the CONSUMER, the CONSUMER shall present to the COMPANY on or before September 20, 1927, receipted bills or other evidence satisfactory to the COMPANY, showing the quantities purchased, from whom purchased (in case Company's products are not purchased directly from the COMPANY), and amounts paid for same by the CONSUMER during the period of this agreement; and the amount of such purchases upon which the Bonus shall be computed shall be the amount actually paid by the CONSUMER for said jewelry; and within thirty days after the presentation of such evidence by the CONSUMER, the COMPANY agrees to deliver direct to the CONSUMER the quantity of jewelry so due as the said Bonus.

6. It is covenanted and agreed that should the CONSUMER violate any of the covenants herein contained, he shall forfeit the right to the said Bonus or to any allowance from the COMPANY herein provided.

7. The term of this agreement shall be from the date hereof up to and including the 10th day of September, 1927.

IN TESTIMONY WHEREOF, the COMPANY has caused this agreement to be signed in its name and the CONSUMER has signed the same the day and year first above stated.

THE ILLINOIS JEWELRY COMPANY,

By
.....

cause of the competition in the trade, however, and to keep the customer's goodwill, the customer was, in fact, allowed the next lower rate of bonus. In determining the total amount of purchases by the contract-holder during a year, the manufacturer had to depend upon the receipted invoices presented by the customer from the wholesale supply houses; there was no other way to ascertain the customer's total gross purchases. No collusion was probable, however, because the wholesaler and the purchaser had directly opposite interests—the larger the bonus to the purchaser, the less he would have to buy in the following year from the wholesaler.

Each month the company followed the practice of debiting a Special Bonus Expense account (a subdivision of the merchandise trading account) and crediting Accounts Payable—Special Bonus (and proper subsidiary accounts) for an amount which represented that month's accrual of the estimated bonus to be paid customers under contracts made to date.² These figures rep-

² At the beginning of each fiscal year, a contract form was sent to each customer who was a large consumer of The Illinois Jewelry Company's products. This contract was properly executed, the customer agreeing to purchase a minimum amount of product, and the company agreeing to the percentage of bonus shown above. If it were assumed that during October, 1926, contracts were executed and returned which would involve bonuses of \$150,000 for the fiscal year, then an entry would be made at October 31, 1926, as follows:

Special Bonus Expense	\$12,500.00	
To Accounts Payable - Special Bonus		\$12,500.00

By the end of November, 1926, still other contracts would probably have been received, showing that the total bonuses for the fiscal year would be a larger sum—say, for example, \$180,000. Since two months have elapsed to date, 2/12 of \$180,000, or \$30,000, should be shown in the accounts. As only \$12,500 was recorded at October 31, 1926, the entry at November 30 would be:

Special Bonus Expense	\$17,500.00	
To Accounts Payable - Special Bonus		\$17,500.00

This entry would bring the proportional part of the year's bonus expense, that is, \$30,000, into the accounts; similar entries were made at the close of the other months.

In making the entries at the close of the year, any one of three courses might have been adopted for adjusting the Special Bonus Expense and the Accounts Payable—Special Bonus accounts, viz:

1. As provided in the contracts the customers were expected to exhibit evidence of their year's purchases on or before September 25. This showed whether or not they had fulfilled their contracts; the actual liability could then have been set up in the books, thus:

Accounts Payable - Special Bonus	\$	
To Customers		\$
Special Bonus Expense		

The estimated liability was thus canceled and the actual liability to customers was substituted. As the actual liability was always less than the estimated, because of the failure of many customers to fulfill their contracts, the excess estimated liability would be transferred to the credit of the Special Bonus Expense account. The net expense then exactly measured or balanced the actual liability; the expense account was closed into the merchandise trading accounts. As rapidly as selections could be made by the customers, the bonus merchandise was shipped and billed to them in the normal way, that is, Sales were credited and the customers' accounts debited.

2. The second method was to leave the estimated liability on the books and close out the Special Bonus Expense account, of the same amount, into the trading account. The

resented, of course, the selling prices of The Illinois Jewelry Company's products; the inventory showed a cost for the year of 21.5% of the regular net selling prices. As soon as possible after the close of the fiscal year, the dealer made his selection of goods, and the accounts were adjusted accordingly.

To determine the actual liability, about 70% of the contracts were analyzed, as follows:

Contract No.	Amount of Contract	Agreed Bonus	Actual Purchases	Actual Bonus Given	Over or Under
2638	\$5,000.00	\$1,000.00	\$2,842.60	\$426.39	u - \$573.61
2022	1,000.00	100.00	830.00		u - 100.00
183	2,500.00	375.00	4,289.28	643.40	o - 268.40

The amounts of the agreed purchases and bonuses were taken from the contracts; the actual purchases were determined from information submitted by customers, and the actual bonuses allowed by the company were computed. You found that the company was ultra-conservative with regard to the amount of this liability; you were satisfied that the liability of \$183,600 set up to cover the bonus was actually much greater than the amount payable under the bonus contract. In some cases no purchases at all were made under the contract; on the basis of all contracts examined, you were convinced that the liability would average slightly less than 75% of the amount provided.

Criticize constructively the verification procedure outlined, and show how you would arrive at the final figures for accounts payable. What caption and amount for each account should appear in the balance sheet to be certified?

adjustment of discrepancies between the estimated and the actual expense thus went over into the succeeding year. The excess liability would be transferred to the credit of the Special Bonus Expense account which is set up for the new lot of contracts for the next year; the adjustment for the current period would thus decrease the special bonus expense for the new period.

3. A modification of the first two methods had usually been practiced. As fast as reports on the contracts were received, the estimated liability was adjusted to the actual liability, as above described. The books were thus closed recording in part the actual liability, and in part the estimated liability. An accounting defect was that the ratio of the actual liability on completed contracts, as determined from those contracts actually adjusted, was not applied to the balance of the estimated liability; the estimated liability was accordingly out of proportion to the actual. There was, of course, a slight possibility that all the contracts on which returns had not been made might produce a 100% actual liability; for that reason no scaling down of the estimated liability had ever been attempted.

Beginning with October, 1927, the second plan described above was to be followed, namely, that the estimated liability and estimated expense would be used in the closing entries. All adjustments were to be made in the succeeding year. The excess liability of any year was to be used to reduce the expense of the next year. The excess liability of the excess liability profits were to be deferred one year; since the amount deferred in each year, however, would not vary greatly from other years, the misstatement of each year's profit and loss would be negligible.

PROBLEM 51

CHARLOTTE MILLS, INCORPORATED—PART IX

Verification of Current Liabilities

At the time of taking up the audit, when you received a copy of the company's trial balances from the comptroller, you proceeded to prepare a working balance sheet, or a working trial balance, which would serve as the "backbone" of your audit; it is probable that the majority, if not all, of the following items were included in this working sheet as current liabilities:¹

<u>Account</u>	<u>Amount</u>
Notes Payable to Banks	\$4,300,000.00
Notes Payable sold through Brokers	1,000,000.00
Vouchers Payable	343,599.30
Cotton Acceptances	239,540.20
Accounts Payable to Selling Companies	91,644.49
Owed for Wages - Mills	110,819.20
Owed for Wages - Others	1,415.00
Accrued Finishing Charges	8,247.71
Unclaimed Wages	2,057.16
Bond Interest Accrued	7,220.00
Suspense Account (P.L. 52)	3,000.00
Reserve for Outstanding Checks	721.30

Notes Payable to Banks

During the early part of the audit, the treasurer had written letters at your request to all banks with which the company had done business during the year past, asking that they send directly to you certificates regarding the company's liability on notes at June 30, 1924.

Letters were received from the several banks, certifying in the aggregate to unsecured outstanding notes of the company in the following amounts:²

¹ These items would be taken from the trial balances (Part I), and should now be carefully checked by the student to the trial balances to ascertain that they are in exact agreement (see pp. 75-79).

² Even if all bankers with whom business has been done during the year are circularized for information as to notes outstanding, it is well to remember that this is not proof that there are not other banks holding notes not entered; indeed, if there is anything of this kind wrong, the improper notes will almost surely be placed with banks which are not on the usual schedule. In one important case notes not on the books were found with over forty banks, all outside the company's regular banks; a prior examination by the company's regular auditor, conducted along the above lines, revealed none of them.

<u>Bank</u>	<u>Note No.</u>	<u>Date</u>	<u>Maturity Date</u>	<u>Interest Rate %</u>	<u>Amount</u>
		1924	1924		
First National Bank	101	6/1	9/1	6	\$2,000,000
" " "	106	6/15	9/15	6	200,000
" " "	107	6/30	9/30	6	100,000
Second National Bank	105	5/15	8/15	6	700,000
Third National Bank	96	4/1	8/1	5½	1,250,000
First Trust Company	104	4/15	7/15	6	50,000
					<u>\$4,300,000</u>

Your previous year's working papers recorded the following notes payable as outstanding at June 30, 1923:

<u>No.</u>	<u>Bank</u>	<u>Date</u>	<u>Maturity</u>	<u>Rate %</u>	<u>Amount</u>	<u>Int. P.P.</u>
		1923	1923			
96	Third National Bank . . .	4/1	8/1	5½	\$1,250,000	\$ 5,729.17
97	First National Bank . . .	4/15	7/15	6	100,000	250.00
98	First Trust Company . . .	4/15	7/15	5½	500,000	1,145.83
99	First Trust Company . . .	5/1	8/1	5½	250,000	1,145.83
100	Second National Bank . . .	5/1	8/1	6	1,000,000	5,000.00
101	First National Bank . . .	6/1	9/1	6	2,000,000	20,000.00
102	Pilgrim Trust Company . . .	6/1	9/1	6	200,000	2,000.00
103	Second National Bank . . .	6/1	9/1	5¾	200,000	1,916.67
					<u>\$5,500,000</u>	<u>\$37,187.50</u>

An analysis of the account for the year showed that the following changes had occurred: Note No. 96 was renewed from time to time; the last renewal date was April 1, 1924 and the maturity date is August 1, 1924. No. 97 was paid July 15, 1923. No. 98 was renewed and paid December 15, 1923. No. 99 was paid August 1, 1923. No. 100 was renewed for one month, and then paid September 1, 1923. No. 101 was renewed and is still outstanding; the last renewal date was June 1, 1924 and the maturity date is September 1, 1924. No. 102 was paid September 1, 1923. No. 103 was renewed for two months and was paid November 1, 1923.

No. 104 for \$50,000 was issued April 15, 1924 to the First Trust Company with interest at 6%, the maturity date being July 15, 1924. No. 105 for \$700,000, with interest at 6%, dated May 15, 1924, and due August 15, 1924, was discounted with the Second National Bank. No. 106 for \$200,000, with interest at 6%, dated June 15, 1924 and due September 15, 1924, was discounted at the First National Bank. No. 107 for \$100,000, with interest at 6%, dated June 30, 1924 and due September 30, 1924,

was discounted at the First National Bank. There was a charge of \$229.20 to the interest account for revenue stamps affixed to notes during the year.³

All payments on account of notes and all interest payments were traced to the cash disbursements book. All notes issued were checked to the stubs of the note book and the cash received was traced to the cash receipts book and as deposits on the bank statements.

Notes Sold Through Brokers

When the treasurer requested confirmations from the banks concerning the notes payable, he also wrote to Messrs. Jones and Smith, Commercial Paper Brokers, 40 Wall Street, New York, requesting them to inform you whether or not any notes of the company had been sold through them. Their certificate contained the following information:

On March 1, 1924, we sold twenty (20) notes of Charlotte Mills, Incorporated, each of a face value of \$50,000 and numbered B1 to B20. Each note was sold for \$48,625 and the commission charged by us for selling these notes was \$2,500. The notes do not bear interest; they mature September 1, 1924.

The net proceeds of these notes, \$970,000, was checked to the cash receipts book, and the portion of the discount deferred was checked to the company's computation.

Vouchers Payable

The general accounting procedure with reference to invoices is as follows:

1. A requisition signed by the head of a department is sent to the purchasing department, after which a purchase order for the article requisitioned is made out by the purchasing agent.
2. The receiving department checks the quantities of goods received and furnishes the accounting department with a daily report of such receipts.
3. The invoices are checked against the purchase orders for quantities and prices and against the receiving record for quantities received. Extensions are checked and the invoices are initialed by the

³ Interest is calculated on a 360-day basis; all interest was deducted in advance. The interest computations should be thoroughly tested by the auditor, in this case the student.

head of the voucher department and by the clerks who did the checking; they are then entered in the voucher register.

4. The invoices are next sent to the treasurer's department and, on the due date, a check is drawn for the payment of each voucher. Checks are signed by the treasurer, or an assistant treasurer, and by the comptroller, or assistant comptroller. (See Part VI of the Problem, p. 222.)

5. The treasurer sends a daily list of the vouchers paid to the voucher department and the voucher clerks mark in the voucher register the respective vouchers paid.

6. Vouchers are filed numerically and are cross-indexed by name.

The comptroller furnished you with a list of the open items in the voucher register at June 30, 1924; this totaled \$343,599.30. The list was checked to the open items in the voucher register as of that date and was found to be correct. Included in the list were the following inter-mill vouchers:

<u>No.</u>	<u>Payer</u>	<u>Account of</u>						<u>Amount</u>	<u>Date Paid</u>
6941	Charlotte Mills, Inc.	Oper. Office	Petty Cash	Expense	Report #126			\$ 243.39	7/3/24
6942	" "	Arlington Mill	" "	" "	" "	213		157.90	"
6943	" "	Boston	" "	" "	" "	114		326.17	"
6944	" "	Cambridge	" "	" "	" "	426		124.05	"
6945	" "	Charlestown	" "	" "	" "	519		165.20	"
6946	" "	Woburn	" "	" "	" "	22		110.02	"
6947	" "	Dorchester	" "	" "	" "	15		255.91	"
6948	" "	Melrose	" "	" "	" "	97		134.56	"
Total								\$1,521.20	

July and August vouchers were examined and invoices totaling \$7,420.19 were found applicable to June purchases; of this amount \$3,450 was for supplies; \$1,695.20 was for cost of printing new stationery; and \$2,274.99 was for repairs in June to auto trucks. The supplies represented by the above invoices were properly included in the physical inventories as of June 30.

Cotton Acceptances

This liability of \$239,540.20 was found to consist of invoices payable for cotton purchases unpaid at June 30, 1924. The accounting procedure for cotton acceptances is the same as for vouchers payable. One voucher entered in July was dated June 28; it was for 94,500 pounds of cotton, bought at \$0.3107 per pound, and which was delivered on July 6 (see Part V). The comptroller's list of unpaid acceptances was checked to the open items in the cotton acceptance book and was found to be correct.

Accounts Payable to Selling Companies

The accounts making up this balance were:

Cotton Products Company	\$57,927.10
Textile Selling Corporation	33,717.39
	<u>\$91,644.49</u>

These balances consist of amounts owed the above companies for commission on cloth sold during the final quarter of the fiscal year ending June 30, 1924. Some of the largest items in both accounts were tested by applying the rates of commission paid to the sales. These balances had been paid in full when examined by you on August 25, 1924.

Owed for Wages—Mills

The payroll period for employees is from Thursday to Wednesday. At June 30, wages were accrued for Thursday, Friday, and Saturday (the mills did not work on Monday, June 30, and Tuesday forenoon, July 1, as inventories were being taken). The payroll records consist of the following:

1. Time clock cards for employees. The hours are punched by clock and on Wednesday evening the cards are sent to the cost department where total hours, rates, and total wages are computed and distributed.

2. Payroll summaries for each mill prepared from the clock cards.

On July 5, 1924, an entry was received from the cost department for the last three working days of June for the wages earned by employees. The total of \$110,819.20 was charged to Manufacturing Expense (as below) and credited to Owed for Wages:

Arlington	\$11,054.26
Boston	35,623.70
Cambridge	11,986.01
Charlestown	10,714.03
Dorchester	17,409.17
Melrose	14,026.05
Woburn	10,005.98

The payroll summaries (amounting to \$167,930.81) representing the week's wages paid on July 5 and which included the wages earned from June 26 to July 2, inclusive, were examined; from a somewhat detailed inspection of the above payroll records, you satisfied yourself that the total of \$110,819.20 was approximately correct for wages earned June 26, 27, and 28,

Owed for Wages—Others

An amount of \$1,415 was set up by the company for salaries of clerks for the last three days of June. This was verified from an examination of the clerical payroll paid on July 6.

Accrued Finishing Charges

This account represents the amounts owed to designers for the use of patterns. The fees paid are based on production; the amounts unpaid at June 30 were tested with the production records, after having examined the agreements with designers.

Unclaimed Wages

Wages not claimed at the time the paymaster visits the mills are held in the envelopes for one week; the amounts are then redeposited in the bank, being charged back to Cash and credited to Unclaimed Wages account. The payrolls are returned to the accounting department where the unsigned names are checked against the payroll envelopes returned; after this is done, the payrolls are permanently filed.

An employee who later claims such unpaid wages must be properly identified; a voucher is then drawn for the amount owed him and he is paid by check, the amount being charged to Unclaimed Wages. The balance of this account represents small amounts running back over several years; the comptroller's list of names and amounts making up the balance was accepted as correct, since the system of internal check was considered good.

Bond Interest Accrued

The balance of this account measures the amount of the interest coupons not presented for payment. By agreement with the trustee under the bond indenture of trust, money deposited with the trustee for the payment of interest and not paid to bondholders is returned to the company one year after the coupons are payable. The amount is debited to Cash and credited to this account. If old coupons are presented to the trustee, they are paid and charged against the company's account at the bank; in the company's books this account is debited. Verification of the account consisted in tracing all credits to the account since the last

audit to the cash receipts book, and all debits to the account to the cash disbursements book; memoranda from the trustee were also seen.

Suspense Account (Private Ledger 52)

There has been no change in this account since the last audit. The balance of \$3,000 was set up in 1918 to show the liability of the company for shipments of coal and cotton received during 1918, for which the company never received invoices.

Reserve for Outstanding Checks

Checks which are not presented to the bank for payment within one year after the date drawn are charged back to Cash and credited to this account and payment is stopped at the bank. This account was verified by tracing to the cash receipts book all checks canceled during the year; all such checks were added back on the check book stub (see Part III, footnote, p. 109).

Finally, after completing all verification work, a general liability certificate was obtained, as follows:

CHARLOTTE MILLS, INCORPORATED
Boston, Massachusetts

August 30, 1924

Certificate of Liabilities

We hereby certify that to the best of our knowledge and belief all known liabilities relating to the period up to and including June 30, 1924, in respect to borrowed money, materials and supplies in transit at June 30, accrued liabilities for taxes, legal fees, damages, etc., have been brought into the books, or have been provided for as of that date.

We further certify that, to the best of our knowledge and belief, no liability, direct or contingent, exists in respect to lawsuits, contracts, or otherwise except such as have been provided for or were specifically brought to the attention of the auditor.

(Signed) George W. Strong
President
John L. Harrison
Treasurer
Jeremiah Addison
Comptroller

Examine critically all verification work done with reference to current liabilities; outline specifically any other procedures

which you believe advisable or necessary. Draft any journal entries necessary to adjust the accounts, and prepare summary schedules for inclusion in your working papers.⁴

PROBLEM 52

CHARLOTTE MILLS, INCORPORATED—PART X

Verification of Funded Debt¹

The funded debt of Charlotte Mills, Incorporated, as shown by your previous year's working papers, consisted of \$5,000,000 of First Mortgage, 20-year, 7% Gold Bonds. The bonds were authorized and issued as of July 1, 1916, and are due June 30, 1936; interest is payable on June 30 and December 31 of each year.²

⁴ See Federal Reserve bulletin, "Verification of Financial Statements," pars. 64-95; Jackson, *Audit Working Papers*, pp. 121-132; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 266-272, 632-633; Bell *Auditing*, pp. 262-272.

¹ Funded liabilities or debt has been defined by the Public Service Commission for the First District of the State of New York as "all debt which by the terms of its creation does not mature until more than one year after date of creation."

² In your permanent file working papers for Charlotte Mills, Incorporated (see Jackson, *Audit Working Papers*, pp. 13-14), you have certain excerpts from the Indenture of Trust securing the First Mortgage bonds; these are as follows:

CHARLOTTE MILLS, INCORPORATED EXCERPTS FROM INDENTURE OF TRUST SECURING FIRST MORTGAGE BONDS

PARTIES. (1) Charlotte Mills, Incorporated, and (2) First Trust Company of Boston, Trustee.

PRINCIPAL. \$5,000,000.

DATE OF ISSUE. July 1, 1916.

MATURITY DATE. June 30, 1936.

INTEREST RATE. 7% per annum.

INTEREST PAYABLE. Semi-annually, on June 30 and December 31, at the offices of the First Trust Company of Boston.

TAX FEATURES

(a) Federal income tax not in excess of 2% per annum on interest payments paid by the borrowing corporation.

(b) Massachusetts income tax not exceeding 6% of the interest received, and the Pennsylvania property tax not exceeding 4 mills, per annum on each dollar of the face amount, will be refunded upon application to holders paying same.

(c) Any succession, inheritance, legacy, or estate taxes are to be paid by owner.

SINKING FUND PROVISIONS. Article I, Par. 4:

"The Company covenants with the Trustee for the benefit of the Trustee and the holders of the bonds, that, so long as any of the bonds remain outstanding, it will pay to the Trustee on the last days of June and December in each year beginning with the last day of December, 1924 as a sinking fund toward the payment of said bonds, a sum of money equal to 2½% of the maximum aggregate principal amount of bonds at any time issued hereunder prior to the date of such payment plus an amount equal to interest to date on each bond theretofore retired through the sinking fund from the date of retirement or the next preceding sinking fund date whichever is most recent. The trustee shall invest at public or private sale or upon tenders, as it may in its discretion determine, the said sinking fund from time to time in the said bonds so far as such bonds to the knowledge of the Trustee can be conveniently obtained, at prices not exceeding the prices at which they may, at the next interest date, be redeemed. And the Trustee may in its discretion but shall not be obliged to do so and at the cost of the Company advertise for such bonds in each or any of the cities of New York, Chicago and Boston once in one or more daily newspapers of said cities. And if and when such bonds cannot be so obtained at such prices within a

The discount and expense on the bonds at the time of their sale and issue was \$416,913.98. This has been amortized in annual instalments of \$20,845.70 to June 30, 1923; the adjusting journal entry for the amortization has been prepared each year by you, as auditor for the company.

Your analysis of the account for the year under audit reveals that at December 31, 1923 the company purchased in the open market \$125,000 of these bonds at 96 and interest. The bonds

period of forty-five days after the date of such sinking fund payment sufficient to substantially exhaust the moneys in the sinking fund, the Trustee shall advise the Company of such fact and the Company shall as hereinafter provided, if the moneys in the Sinking Fund amount to at least \$20,000, call as many of the said bonds for redemption at the next interest date as the Trustee shall deem sufficient to substantially exhaust the moneys held in the sinking fund.

"Bonds purchased or redeemed shall be canceled.

"In lieu of money, and at the price at which the next interest date they may be redeemed, including accrued interest, the Company may deliver to the Trustee bonds secured hereby previously purchased by it equal to the whole or any part of the money then due on account of sinking fund requirements."

REDEMPTION OF BONDS. Article I, Par. 5:

"Any one or all of the issue of bonds may be redeemed, at the election of the promisor, on any interest date before maturity by complying with the following requirements:

- (a) Shall notify the Trustee in writing of its intention so to do, the amount of bonds to be redeemed and the interest date fixed therefor (which date shall be at least 35 days after the giving of notice).
- (b) The Trustee shall determine by lot the bonds to be so redeemed and the Company shall notify the holders thereof by publication at least four times in newspapers in the cities of New York, Chicago, and Boston.
- (c) Before such redemption date the Company shall pay to the Trustee the amount required to pay and redeem the bonds so specified at the redemption price then in effect and the accrued interest thereon to date of redemption.
- (d) Upon presentation of his bond with all unmatured coupons attached, the holder shall receive from the Trustee the principal of his bond, accrued interest to date, and a premium as specified below:

If any bond shall be redeemed before July 1, 1917, such premium shall be 9½%; if redeemed on or after July 1, 1917 but before January 1, 1918, the premium shall be 9¼% and so on, the premium decreasing ¼% each interest period until the date of maturity when the bonds shall be redeemed at par."

PURCHASE OF BONDS IN OPEN MARKET. "No provision in the redemption clause of the Indenture shall be construed so as to prohibit the Company or the Trustee from purchasing bonds in the open market when the purchase price in the open market is lower than the redemption price."

SALE OF PARTS OF THE MORTGAGED PREMISES NO LONGER USEFUL. "The Company may, whenever it is not in default in respect to the payment of the principal or interest of the bonds, or of any sinking fund payment, sell any of the mortgaged property, and the Trustee shall release such property upon receipt of the proceeds of the sale and upon being furnished a certificate that the property to be sold is no longer of use in the conduct of the business and that the price to be received is a fair price and represents the fair value of such property. The proceeds of such sales shall be held and invested by the Trustee until, and if, the Company furnishes the Trustee with a certificate that additional property has been purchased, or that additions, betterments, or improvements have been made of equal value. The proceeds will then be paid to the Company by the Trustee as reimbursement for the expenditures made for such purchases or improvements."

INSURANCE. "The Company agrees to keep the premises covered by this Indenture fully insured and all policies are to be deposited with the Trustee."

TAXES. "The Company agrees to pay promptly all taxes, liens, etc., on the property."

FINANCIAL STATEMENT. "The Company agrees to furnish to the Trustee at least once in every six months, and at such other times as the Trustee in its discretion may demand in writing, a full statement of its current financial affairs."

NET QUICK ASSETS TO BE MAINTAINED AT 50% OF BONDS. The Company, "so long as any of the bonds remain outstanding, will always own and have full use of net quick or current assets as hereinafter defined equal to at least 50% of the par value of the bonds outstanding plus those which have been retired by operation of the sinking fund."

NET QUICK ASSETS DEFINED. "The term 'net quick assets' or 'net current assets' as used herein shall be deemed to mean the excess of assets of the Company which by the general custom of recognized accountants is considered 'quick or current' over the liabilities of the Company, which by such general custom of recognized accountants is considered 'quick or current' liabilities, and the bonds issued hereunder shall at no time be considered 'quick or current' liabilities."

were charged to an account, Bonds Retired, in the private ledger; Surplus was credited for the amount of the discount. Although the bonds were charged to a Bonds Retired account, they were not actually canceled but were held alive in the treasury; these 125 bonds were inspected by you at the time of the security count, and it was noted that the interest coupons due June 30, 1924 were attached.

To confirm the amount of bonds outstanding as at June 30, 1924, you had prepared, soon after taking up the verification work of the audit, the customary request for confirmation; the following letter was received from the trustee:

FIRST TRUST COMPANY
40 State Street
Boston, Massachusetts

August 15, 1924.

Mr. J. M. Goode, C.P.A.,
First National Bank Building,
Boston, Massachusetts.

Dear Sir:

Charlotte Mills, Incorporated

We have received, under date of August 10, a request from the above Company asking that we certify to you the amount of that Company's First Mortgage, 20-year, 7% Gold Bonds outstanding as of June 30, 1924. At that date there were outstanding \$5,000,000 par value of the bonds.

We further state, in accordance with the request of Charlotte Mills, Incorporated, that the interest on these bonds was paid in full as of June 30, 1924.

Yours very truly,
FIRST TRUST COMPANY
(Signed) Timothy Accurate
Treasurer

You made an analysis of the Bond Interest account and traced the semi-annual interest payments to the cash book. You also saw the canceled checks, under dates of December 30, 1923 and June 29, 1924, for \$175,000 each, payable to the "First Trust Company, Trustee"; each check contained a notation to the effect that it was in payment of the bond interest due on the day following.

Criticize constructively the verification procedure as outlined; prepare any adjusting journal entries which should be

made, and draw up summary working schedules for the work done of the audit.³

PROBLEM 53

THE XANTHUS OPERATING COMPANY

Contingent Liability as Guarantor of Purchase Money Notes

You have audited the books and accounts of The Xanthus Operating Company for the fiscal year ended December 31, 1925, and of its subsidiary, The Zinthus Transportation Company. You find that the parent company is guarantor of the principal of \$6,500,000 and interest at 6% per annum for the purchase, by the subsidiary company, of 1,000 tank cars over a period of 130 months from January 15, 1925; the principal sum is to be paid in equal monthly instalments by The Zinthus Transportation Company.

How should this liability be shown in the balance sheet of The Xanthus Operating Company, (a) when a consolidated balance sheet is to be given, or (b) when separate balance sheets for the parent and subsidiary company are to be issued? What verification should you, as auditor, make of the above?

PROBLEM 54

ANDREAS PRODUCING COMPANY

Guaranty of Affiliated Company's Notes

The Andreas Producing Company has a one-half interest in the Best Distributing Company, the other one-half of which is owned by The Candow Agencies, Inc., a competitor of the Andreas Producing Company. At December 31, 1928, the Best Distributing Company had short-term notes outstanding in the amount of \$50,000,000, bearing interest at the rate of $5\frac{1}{2}\%$ per annum. As security for these notes the two owning companies

³ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 276-280; Dickinson, *Accounting Practice and Procedure*, pp. 116-118, 133-143; Jackson, *Audit Working Papers*, pp. 118-120.

have executed a contract by which they agree to buy at any time on demand of the Best Distributing Company the entire amount of crude oil then owned by it for an aggregate sum of \$53,600,000 cash, each owning company being obligated for one-half of this sum. In the certified balance sheet of the Andreas Producing Company, as of December 31, 1928, no reference was made, either in the balance sheet itself or in the auditor's certificate, to the above agreement.

In due course the Andreas Producing Company presented its balance sheet, as certified by the accountant, to its bank. Upon discussion the bank learned of the contract with the Best Distributing Company; the bank maintained that this was a contract to purchase an indeterminate amount of oil for a determinate amount of cash irrespective of current prices—in fact, the banker stated that it appeared to be a subterfuge for an outright guaranty. In either case the banker stated that it appeared that this was a definite contingent liability which should have been commented on by the auditor either in the balance sheet itself or in the certificate attached to the balance sheet.

Do you agree with the banker? Explain.

PROBLEM 55

EUROPEAN DISTRIBUTORS, INC.

Outstanding Bills of Exchange

The certified balance sheet of European Distributors, Inc., as of June 30, 1928, made no mention of contingent liabilities although at that time there was several hundred thousand dollars of outstanding bills of exchange. The bank, to which the company's balance sheet was presented as the basis for a line of credit, took the matter up with the auditor who certified the accounts; the auditor's reply was that as the bills of exchange were drawn on the parent house in Europe the company did not consider them a liability, and that accordingly he did not make mention of any contingent liability from this source,

Was the auditor in error? Comment.

PROBLEM 56**OPULENT MANUFACTURING COMPANY****Contingent Liability**

A printed certified balance sheet, as of December 31, 1928, of the Opulent Manufacturing Company, a company whose capital stock is traded in actively on the New York Stock Exchange, made no reference, either in the balance sheet itself or in the certificate attached thereto, to contingent liabilities. This certified statement was submitted to the company's banks as a basis on which a line of credit should be extended; there was already a contingent liability of several million dollars to these several banks because of notes receivable discounted.

One of the banks immediately got in touch with the accountant who certified the balance sheet, and discussed the situation with him; he stated that, after consulting with the company's officials, it had been decided not to show this contingent liability, because the officials believed, and he concurred in that belief, that the actual contingency was remote because the notes were well secured. The auditor stated that the company had a very definite policy with reference to sales—at the time a sale was made the purchaser made an initial payment of 25% in cash, and gave notes running serially from one to twelve months for the balance. These notes were secured by a lien on the article sold, and by insurance against fire and theft.

The bank informed the accountant that in its opinion the certified balance sheet of December 31 was not a complete showing of the company's affairs, and that it objected to any accounting firm putting itself in the position of deciding whether or not the chance of loss on such discounted notes was small; the bank preferred to make that decision for itself, on the basis of full and complete information to be furnished.

Was the contention of the bank correct, and the accountant in error? Comment.

PROBLEM 57

THE PATENT PROCESS COMPANY

Provisions for Depreciation and Sinking Fund Reserves

During 1926, The Patent Process Company entered into a contract to purchase, as of January 1, 1927, a certain patent device for the sum of \$375,000; the patent had fifteen years yet to run. In order to pay for the patent the company sold at par \$375,000 of 6½% serial bonds, maturing in instalments of \$25,000 annually for fifteen years. Because of possible competition, and obsolescence of the company's property, it was provided in the indenture of trust under which the bonds were issued that a sinking fund reserve should be set up in the accounts, the annual instalments of \$25,000 to be charged against the earnings of the year "before arriving at the net profit."

The president of The Patent Process Company, however, had a contract with the company under the terms of which he was to receive as compensation additional to his salary 5% of the net profits of the year; it was specifically understood that in his case "net profit" was to be arrived at before charging the sinking fund reserve instalment of the year.

The accounts of The Patent Process Company were audited for the fiscal year ended December 31, 1927 by Messrs. Crane & Watson, Certified Public Accountants. In preparing the accounts for certification the auditors wrote off as "depreciation of patents" one-fifteenth of the purchase price of the above patent device, or \$25,000; this amount was included among the operating expenses of the period under audit. As provided in the trust indenture the provision for the sinking fund reserve was also included as a charge against the earnings of the year.

When the accounts were submitted to the directors, the president referred to his contract with the company and maintained that the provisions for depreciation and for sinking fund were one and the same, and that he was entitled to 5% of the earnings before any deduction was made for the depreciation of patents. He further maintained that both of these provisions were unnecessary—the depreciation provision was merely a duplication

of the provision for sinking fund, and the net profits of the company were thereby understated by \$25,000.

Were the auditors justified in providing for depreciation on the patent device? Or, was the president correct in maintaining that the charge was a mere duplication, and that he was entitled to his bonus before it was taken into account? Be prepared to defend your views with reference to these matters.¹

PROBLEM 58

BROOKLINE MANUFACTURING COMPANY

Audit for Verification of Reserve for Sinking Fund

The Brookline Manufacturing Company issued, as of November 1, 1925, \$1,250,000 of 6% first mortgage gold bonds, with interest payable semi-annually, and maturing November 1, 1935.

The indenture of trust covering the issue of bonds provided that the company "shall pay to the Trustee on or before the first day of November, 1927, and the first days of each May and November thereafter until the date of the maturity of the bonds, the sum of \$62,500, plus such amount as the semi-annual interest on the bonds which have been retired or may have been acquired by the company would amount to if such bonds were outstanding or owned by other persons, so that the aggregate amount of this Sinking Fund and of the interest on the outstanding bonds held by other persons shall in each year be not less than \$200,000, such payment to be made as a Sinking Fund to be expended in accordance with the provisions of this section for the retirement of the bonds issued hereunder." The section provided that the bonds might be purchased in the open market up to 110%, or might be called at 110%.

The indenture further provided that: "Net income shall mean gross income from all sources received during the period in question, less all expenses and losses of operation during such period,

¹ See Hatfield, *Accounting*, pp. 341-342; Jackson, *Audit Working Papers*, pp. 140-143; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 336-337; Bell, *Auditing*, pp. 298-301.

including maintenance, reasonable depreciation, interest paid by the Company, and the Sinking Fund provided for in this section, ..."

It was also covenanted by the company that "50% of the net profits, as defined above, will be set aside as a Special Sinking Fund Reserve, this fund also to be used to redeem bonds at the market, but not to exceed 102%."

A further covenant of the company was that it "will cause its books to be audited each year, on or before the first day of April, by a certified public accountant or by a firm of certified public accountants, and will deliver to the Trustee a certified statement showing in detail the net income of the Company for the preceding calendar year." In accordance with this covenant, you are engaged to audit the books and accounts of the said company for the year ended December 31, 1928.¹

In addition to the books, records and vouchers of the company, you are furnished with the financial statements of the year as prepared by the company's accounting department; you are also furnished with the trustee's statement of the sinking fund, which you may assume to be correct. The trustee's statement is as follows:

TRUSTEE'S STATEMENT OF SINKING FUND
(from beginning)

1927 - Cash received from Company	\$ 62,500.00	
Bank interest credited	149.50	
	<u>\$ 62,649.50</u>	
Bonds redeemed (par value, \$60,000)	\$61,500.00	
Accrued interest on above	440.24	
	<u>61,940.24</u>	
1928 - Balance carried forward	\$ 709.26	
Cash received (May 1, 1928)	64,300.00	
" " (November 1, 1928)	66,160.00	
Bank interest credited for the year	241.75	
	<u>\$131,411.01</u>	
May 15 - Bonds redeemed (par value, \$62,000)	\$64,382.50	
Accrued interest on above	115.00	
Dec. 1 - Bonds redeemed (par value, \$64,000)	66,365.75	
Accrued interest on above	320.00	
	<u>131,183.25</u>	
Trustee's balance, December 31, 1928	<u>\$ 227.76</u>	

The statement of profit and loss for the year ended December 31, 1928, as prepared by the company, was as follows:

¹ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 336-337.

STATEMENT OF PROFIT AND LOSS
for the Year ended December 31, 1928

Net Profit from Operations	\$575,392.80	
Add: Other Income: -		
Interest received - Sinking Fund	241.75	
		<u>\$575,634.55</u>
Deduct:		
Home Office Expenses	\$ 59,644.87	
Interest on First Mortgage Bonds	68,205.00	
Reserve for Sinking Fund	21,335.00	
Reserve for Depreciation of Equipment	112,770.72	
Reserve for Depletion of Wasting Assets	180,910.40	
Adjustment of Inventories	6,098.20	
Reduction in value of Plants from war prices at which they were purchased	96,000.00	
Loss on redemption of First Mortgage Bonds	4,748.25	<u>549,712.44</u>
Net Profit transferred to Surplus		<u>\$ 25,922.11</u>

The company's accountant explained that he had only charged \$89,540 (\$68,205 interest on bonds, and \$21,335 reserved in November and December, 1928 for redemption of bonds) against the earnings of the period because the company has paid over to the trustee the difference, or \$110,460. This latter amount (that is, \$200,000 less \$89,540) the accountant informs you represents the amount reserved from January to October inclusive for the redemption of bonds; it was paid in cash to the trustee, and was used by it for the redemption of bonds—accordingly the \$110,460 offset the charges previously made against the earnings.

The Surplus account as of the close of the year follows:

SURPLUS, DECEMBER 31, 1928

Deficit, January 1, 1928		\$101,326.42
Deduct:		
Sinking Fund Reserve, 1927	\$62,500.00	
Interest on Sinking Fund, 1927	149.50	
	<u>\$62,649.50</u>	
Less: Loss on Bonds retired during 1927	1,500.00	61,149.50
Adjusted Deficit, January 1, 1928		<u>\$ 40,176.92</u>
Deduct: Net Profit for 1928 (per Statement of Profit and Loss)	\$25,922.11	
Less: Provision for Federal Income Taxes for the calendar year 1928	None ²	
	<u>\$25,922.11</u>	
Less: Reserve for Special Sinking Fund, amounting to 50% of the year's profits	12,961.05	12,961.06
Deficit, December 31, 1928, per Balance Sheet		<u>\$ 27,215.86</u>

² There was a statutory net loss carried forward from 1927 which more than equaled the taxable profits of 1928. See Revenue Act of 1928, Section 117, (b) and (c).

The balance sheet as of December 31 was as follows:

BALANCE SHEET, DECEMBER 31, 1928

ASSETS

Current Assets (net)	\$ 465,296.84	
Investments, at book value	70,000.00	
Deposit with Trustee of Sinking Fund	227.76	
Properties (net, after deducting depreciation reserves)	1,949,467.28	
Deficit (per Surplus account above)	27,215.86	
	<u>\$2,512,207.74</u>	

LIABILITIES AND CAPITAL

Current Liabilities, including accruals	\$ 412,299.30	
First Mortgage Bonds, 1935:		
Issued	\$1,250,000.00	
Retired by sinking fund	<u>186,000.00</u>	1,064,000.00
Special Reserves:		
Reserve for Sinking Fund for First Mortgage bonds	\$ 21,335.00	
Special Reserve for Sinking Fund for First Mortgage Bonds	12,961.05	
Miscellaneous	<u>1,612.39</u>	35,908.44
Capital Stock:		
Authorized and Outstanding:		
10,000 shares of \$100 each		<u>1,000,000.00</u>
		<u>\$2,512,207.74</u>

You may assume that all amounts in the statement of profit and loss, the Surplus account, and the balance sheet not definitely referring to the sinking fund reserves are correctly stated; all other amounts you are required to verify, and, if incorrect, to change them so that they will conform to the provisions of the indenture of trust referred to above (obviously if any of these amounts require adjustment there will be corresponding adjustments elsewhere). What specific verification would you make of the sinking fund transactions of the year?³

PROBLEM 59

S. O. S. CORPORATION

Audit of Reserve for Contingencies

In auditing the books of the S. O. S. Corporation for the fiscal year ended December 31, 1922, an auditor found that the net profit for the year, as shown by the company's books of account and as published in the metropolitan financial newspapers, was \$10,330,000. The audit showed that this profit was real and actual except in so far as it might be affected by the analysis and verification of the Reserve for Contingencies account appearing in the company's general ledger.

The reserve for contingencies account for the year under audit consisted of several pages of miscellaneous items. The analysis of the account, and the classification of the amounts entered therein, resulted in the summary shown on page 292.

The opening balance as of December 31, 1921 was shown in the auditor's working papers of the previous year to consist of \$3,000,000 to provide against a drop in value of inventories, and \$1,500,000 as a general safety reserve.

The client will oppose absolutely any change which the auditor may propose to make in the net profit figure already published; the auditor must therefore have very valid reasons for any change he proposes to make.

³ See Hatfield, *Accounting*, pp. 334-336, 338-339, 341; Bell, *Auditing*, pp. 298-301; Jackson, *Audit Working Papers*, pp. 139-143.

<u>Items</u>	<u>Debits</u>	<u>Credits</u>
Balance, December 31, 1921, per previous audit papers		\$ 4,500,000.00
Adjustment of above balance to Profit and Loss (miscellaneous items - found OK)	\$ 80,000.00	
Adjustment for foreign exchange		6,000.00
Adjustment for bond discount		40,000.00
Settlement of U. S. Government war contract claims		1,850,000.00
Provision for inventory adjustment		600,000.00
Inventory write-down to market, not shown in P. & L. account	5,300,000.00	
Miscel. expense items capitalized		170,000.00
Transfer of excess balance from Reserve for Federal Taxes		4,500,000.00
Court judgment of previous year	20,000.00	
Other legal expenses	16,000.00	
Balance, December 31, 1922	6,250,000.00	
	<u>\$11,666,000.00</u>	<u>\$11,666,000.00</u>
Balance down, January 1, 1923		\$ 6,250,000.00

In completing his audit what attitude should the auditor take towards the above facts, and what net profit should he be willing to certify to for the fiscal year ended December 31, 1922?¹

PROBLEM 60

CHARLOTTE MILLS, INCORPORATED—PART XI

Verification of Capital Stock

In the verification of the capital stock you followed the usual procedure, where there are public registrars or transfer agents for the several issues, of securing certificates stating the amounts of the various classes of stock outstanding. The request for these certificates was sent soon after taking up the audit, in order that the confirmations would be on hand when this part of the verification work of the audit would be done.¹ The following letter was received from the transfer agent:

¹ See Hatfield, *Accounting*, p. 323, final paragraph.

¹ Such requests for confirmations should ordinarily be drafted by the auditor, in order to make certain that all the information needed will be requested; the letter will then be typed by the client's staff, and signed by the proper official of the business under audit. The confirmations will be mailed directly to the auditor, and will be incorporated by him in his working papers (see Jackson, *Audit Working Papers*, Appendix A, Schedule AA-1).

PILGRIM TRUST COMPANY
320 State Street
Boston, Massachusetts

August 16, 1924

Mr. J. M. Goode, C.P.A.,
First National Bank Building,
Boston, Massachusetts.

Dear Sir :

Charlotte Mills, Incorporated

In accordance with the request of August tenth of Charlotte Mills, Incorporated, we are giving you the following information concerning the various issues of capital stock of that company outstanding at June 30, 1924:

<u>Issue</u>	<u>Shares Outstanding</u>
6% Cum. First Preferred	10,000 - \$100 par value
7% Cum. Second Preferred	30,000 - \$100 par value
Common	1,000,000 - no-par value

Yours very truly,
PILGRIM TRUST COMPANY
(Signed) John Trustworthy
Trust Officer

During the course of the audit, you noted the following information concerning the various issues of capital stock :

First Preferred Stock

There was no change in this account in the private ledger during the year under audit. Previous working papers show that 10,000 shares of this stock were authorized at the time of incorporation of the company, and were issued in payment for properties acquired. The par value of the stock is \$100 per share; dividends are cumulative, and are payable on June 30 and December 31, to stockholders of record of June 20 and December 20, respectively, at the rate of 6% per annum. The stock is preferred as to assets; in case of liquidation the holders of this issue of stock shall receive \$105 per share before the common stockholders receive anything. After July 1, 1935 the stock is callable at 105 and accrued dividend, in full or in part on any dividend date, upon ninety days' notice. The stock does not have voting rights, unless and until four dividends have been passed; in that case the holders of the first preferred stock shall have exclusive

right to elect the directors of the corporation, and shall continue to exercise this right until all dividends in arrears shall have been paid.

Your subsequent examination of the surplus account shows that the dividends of December 31, 1923 and June 30, 1924 were declared, and your examination of the cash records shows that the dividends were paid. Your examination of the minutes showed proper resolutions for their declaration (see page 223).

Second Preferred Stock

The balance of this account at June 30, 1923, as shown by the previous year's working papers, was \$1,500,000. This was represented by 15,000 shares, of a par value of \$100 per share, of 7% cumulative preferred stock outstanding; dividends are payable on April 1 and October 1, to stockholders of record ten days previously. The total authorized stock of this issue is 30,000 shares; the stock is not preferred as to assets, and has no voting rights. It is callable as of any dividend date, at 110 and accrued dividend, upon sixty days' notice.

On August 11, 1923, the stockholders at a special meeting authorized the sale and issue of 15,000 additional shares. These were sold at par as of October 1, 1923. At June 30, 1924, all subscriptions to this issue had been paid except the following:

Cotton Products Company	2,000 shares	\$200,000.00
Textile Selling Corporation	2,000 shares	200,000.00
Textile Foreign Selling Corporation	1,000 shares	100,000.00
		<u>\$500,000.00</u>
Interest at 6% accrued on these balances to June 30, 1924 (net)		5,000.00
P.L. 12. Accounts Receivable - Stock Subscriptions		<u>\$505,000.00</u>

Liberty bonds of a par value of \$300,000 are in the possession of the treasurer to secure payment of these subscriptions.

Common Stock

No change has occurred in this account since the last audit. Previous working papers show that 2,500,000 shares of no-par common stock were authorized at the time the company was organized; at that time 1,000,000 shares were issued. This issue represented the net equity of \$12,654,725.30 of the common stockholders at the date of incorporation,

Criticize constructively the verification outlined above, prepare any adjusting journal entries needed, and draw up working schedules to summarize the work done on the audit.²

PROBLEM 61

THE DAVISON SUPPLY COMPANY

Verification of Capital Stock

The Davison Supply Company, Philadelphia, a company organized under the laws of the Commonwealth of Pennsylvania, manufactured and distributed dental supplies of all sorts, including office equipment, instruments, and teeth. The business was started in 1900, and was conducted for several years as a partnership; upon incorporation the four partners became and continued to be the main stockholders of the company. The original investment was \$50,000; at the date of your audit, December 31, 1927, there were outstanding common stock of \$3,000,000 and 7% cumulative preferred stock of \$1,000,000. The common stock was represented by the original investment, plus earnings not withdrawn from the business; the preferred stock had been sold at par in 1915.

During the course of this your first audit of the company's accounts, you found that the company transferred and registered its own stock, having neither public registrar nor transfer agent. You proceeded to verify the capital stock accounts accordingly. A copy of the charter, or certificate of incorporation, was obtained; this stated the authorized capital stock as \$5,000,000 common (50,000 shares of a par value of \$100 each), and \$2,000,000 7% cumulative preferred (20,000 shares of a par value of \$100 each).

An examination of the corporation by-laws, and of the minutes of the stockholders and board of directors was also made; from these you ascertained the amounts of the various issues of stock, and satisfied yourself that all issues had been properly authorized by the corporation's stockholders and directors. An analysis of the general ledger accounts was made, which showed the following results:

² See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 318-328; Jackson, *Audit Working Papers*, pp. 113-115, and Appendix A, Schedules AA-AA'.

THE DAVISON SUPPLY COMPANY
Analysis of Common Stock, December 31, 1927

Capital stock issued, for total assets of the partnership, at date of organization of company, January 3, 1905	\$ 100,000.00
Stock dividend, July 15, 1910, of 100%, per stockholders' resolution of June 20, 1910	100,000.00
Stock dividend, January 15, 1914, of 150%, per stockholders' resolution of December 20, 1913	300,000.00
Stock dividend, October 15, 1917, of 60%, per stockholders' resolution of September 24, 1917	300,000.00
Stock dividend, January 15, 1923, of 150%, per stockholders' resolution of December 2, 1922	1,200,000.00
Stock dividend, July 15, 1925, of 50%, per stockholders' resolution of June 12, 1925	<u>1,000,000.00</u>
Balance of common stock outstanding, December 31, 1927, per the general ledger account	\$3,000,000.00

An examination and analysis of the Surplus account showed that the contra entries for all the stock dividends had been to Surplus. Your perusal of the minutes had also revealed that the company had paid annually cash dividends on the common stock of 10%; there was payable on January 15, 1928, the regular quarterly dividend of $2\frac{1}{2}\%$, plus a special cash dividend of 10%. These amounts had been charged against the profit and loss account at December 31, 1927, and set up in the accounts as a current liability.

The analysis of the preferred capital stock account was as follows:

THE DAVISON SUPPLY COMPANY
Analysis of Preferred Stock, December 31, 1927

Preferred Stock sold for cash at par during July–September, 1915	\$1,000,000.00
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This represented the balance of the preferred stock outstanding at December 31, 1927, per the general ledger account. The cash book was examined for the months July to September, 1915, and it was ascertained that entries appeared in the cash book for the \$1,000,000 of preferred stock sold.

You then proceeded to obtain from the secretary of the corporation all stock certificate books; the secretary gave you two books of 500 certificates each for the common stock, and one book of 500 certificates for the preferred stock. He stated that these represented all certificates that had been engraved to date, it being improbable that more would be needed for many years. The

stock certificates were numbered consecutively, and stubs were provided on which were recorded the date on which the certificate was issued, the name of the person to whom issued, and the number of shares represented by the certificate; the stub also provided for recording the date of cancellation of the certificate and the party to whom the shares were transferred.

The stock ledgers were next obtained from the comptroller's department. Cards, 5 by 7 inches, were used for the stock ledgers; they were arranged alphabetically and showed the numbers of certificates and total shares issued to each stockholder, the shares transferred, and the balance of shares owned by the stockholder; one set of cards was for the common stock, and another set for the preferred stock.

The stock certificate books were then examined; it was observed that all canceled certificates had been reattached to the stubs, and that the certificates had actually been canceled, that is, perforated or otherwise mutilated, so that they could not again be issued. You noted that federal revenue stamps had been attached to all stubs for certificates issued¹—this tax on the original issue of the stock is 5 cents per share or fraction thereof; also, in the case of all certificates transferred there were attached federal revenue stamps of 2 cents per share or fraction thereof, and Pennsylvania stamps of 2 cents for each share or fraction thereof. The stamps also had been canceled in accordance with the requirements of the law. You found that the stock outstanding, as shown by the stubs of the stock certificate books, was in agreement with the general ledger accounts; you found also that the stock certificate books and the stock ledgers were in agreement. These facts you scheduled for inclusion in your working papers, as follows:

¹ The Revenue Acts of 1926 and 1928 provide that "on each original issue, whether on organization or reorganization, of certificates of stock, or of profits, or of interest in property or accumulations, by any corporation," there shall be a tax "on each \$100 of face value or fraction thereof, 5 cents: Provided, that where a certificate is issued without face value, the tax shall be 5 cents per share, unless the actual value is in excess of \$100 per share, in which case the tax shall be 5 cents on each \$100 of actual value or fraction thereof, or unless the actual value is less than \$100 per share, in which case the tax shall be 1 cent on each \$20 of actual value, or fraction thereof." The earlier Revenue Acts, beginning with 1917, contained similar provisions.

The Revenue Acts also provide that "the stamps representing the tax imposed by this subdivision shall be attached to the stock books and not to the certificates issued."

THE DAVISON SUPPLY COMPANY
Common Capital Stock, December 31, 1927

Stock Certi- cate Number	Name	Certificate Book Number of Shares	Stock Ledger Trial Balance	Remarks
1-5	Canceled			All certificates re ceived for.
6	Grace E. Browne	435	660	
7-15	Canceled			
16	John T. Williams	250	750	
17	John T. Williams, Jr.	250	500	
18-60	M. H. Jackson (100 sh. each)	4,300	6,000	
61	Canceled			
62	Margaret E. Greene	5	5	
63	Ethel L. Campbell	5	5	
64-80	K. M. Sheppard (100 sh. each)	1,700	6,000	
81-90	Helen Sheppard (100 sh. each)	1,000	1,000	
91	James Edwards	16	25	
92	T. S. Smith	10	10	
93-102	A. B. Crampton (100 sh. each)	1,000	6,000	
103	Viola Osborn	5	5	
104	Grace E. Browne	225		
105-110	C. M. Hughes (500 sh. each)	3,000	6,000	
111	M. H. Jackson	1,000		
112	Elizabeth Evans	5	5	
113	J. K. Jessup	15	15	
114	James Edwards	9		
115-118	K. M. Sheppard (500 sh. each)	2,000		
119-123	John T. Williams (100 sh. each)	500		
124-128	A. B. Crampton (1000 sh. each)	5,000		
129-130	Virginia Crampton (500 sh. each)	1,000	1,000	
131-137	M. H. Jackson (100 sh. each)	700		
138	Canceled			
139	Dorothy Campbell	10	10	
140-144	John T. Williams, Jr. (50 sh. each)	250		
145	K. M. Sheppard	2,000		
146-148	K. M. Sheppard (100 sh. each)	300		

(Continued)

Stock Certificate Number	Name	Certificate Book Number of Shares	Stock Ledger Trial Balance	Remarks
149	C. M. Hughes	1,000		
150	Canceled			
151	Walter Welsh	10	10	
152-153	C. M. Hughes (1,000 sh. each)	2,000		
154-155	Grace Hughes (500 sh. each)	1,000	1,000	
156-157	Canceled			
158	Leroy Edwards	100	100	
159	M. R. Simmons	100	100	
160	J. O. Wilson	100	100	
161	Canceled			
162	V. S. Ward	100	100	
163	F. E. Kittredge	100	100	
164	M. H. Finley	100	100	
165	R. J. Bingham	100	100	
166	M. F. Frazier	100	100	
167	O. H. Thomas	100	100	
168	E. L. Phillips	50	50	
169	Ruth Phillips	50	50	
170-499	Intact			Certificate No. 500 stated by Secretary to have been given the Green Chemical Co. as sample.
500	Sample			
501-1000	Intact			
	30,000 shares at \$100 = \$3,000,000 To <u>B/S</u>	30,000	30,000	

All canceled certificates are attached to certificate stubs, all revenue stamps are properly attached and canceled, and all stock certificates are receipted for.

The common stock quarterly dividend of $2\frac{1}{4}\%$ payable January 15, 1928, and also a 10% special cash dividend payable on the same date, have been included in the current liabilities at December 31, 1927. The dividends paid during the year were traced into the cash book; all dividends declared were properly authorized in the directors' minutes.

THE DAVISON SUPPLY COMPANY
Preferred Capital Stock, December 31, 1927

Stock Certificate Number	Name	Certificate Book Number of Shares	Stock Ledger Trial Balance	Remarks
1-3	Canceled			
4	Grace E. Browne	500	1,500	
5	Canceled			
6	K. M. Sheppard	1,000	1,000	All certificates re- ceipted for.
7-8	Canceled			
9	Virginia Crampton	500	1,000	
10	C. M. Hughes	1,000	1,000	
11	Dorothy Campbell	15	15	
12	Grace E. Browne	100		
13	Helen Sheppard	100	1,000	
14	Elizabeth Evans	5	5	
15-19	Grace Hughes (100 sh. each)	500	1,000	
20-29	M. H. Jackson (100 sh. each)	1,000	1,000	
30-34	Virginia Crampton (100 sh. each)	500		
35	J. K. Jessup	10	10	
36	Canceled			
37-45	Grace E. Browne (100 sh. each)	900		
46-47	A. B. Crampton (100 sh. each)	200	1,000	
48	Margaret E. Greene	5	5	
49	James Edwards	15	15	
50-58	Helen Sheppard (100 sh. each)	900		
59	Ruth Phillips	100	100	
60-64	Grace Hughes (100 sh. each)	500		
65	Leroy Edwards	50	50	
66	Esther Simmons	100	100	
67-72	Primrose Williams (100 sh. each)	600	600	
73-80	A. B. Crampton (100 sh. each)	800		
81	Ethel L. Campbell	10	10	
82	John T. Williams	500	500	
83	John T. Williams, Jr.	90	90	
84-500	Intact			
		10,000	10,000	
	10,000 shares at \$100 = \$1,000,000 To B/S			

All canceled certificates are attached to certificate stubs, all revenue stamps are attached and canceled, and all stock certificates are properly receipted for. The minutes were examined to see that all dividends have been declared, and the dividend payments for the current year were traced into the cash book. The preferred dividend payable January 15, 1928 has been declared, and is included in the current accounts payable in the accounts.

On the basis of the above verification,² and of general information obtained during the course of the audit, you believed that

² Instead of listing the outstanding stock certificates in detail, as shown in the preceding verification, some auditors would schedule the work more as follows:

Balance, 12/31/1926, per Working Papers	\$
Less: Certificates canceled during year	\$
Plus: Certificates issued during year	\$
Balance, 12/31/1927, per Ledger	\$

Either method of scheduling the results involves the same procedure in verifying the capital stock outstanding,

the capital stock accounts were correctly stated. You recognized that it was possible for the company to have outstanding other certificates of stock; however, you considered that you had taken all reasonable precautions, and that you were not warranted in giving more time to that part of the verification.

Comment upon the procedure outlined above; how would it be possible for other certificates of stock to be outstanding? ³

PROBLEM 62

U. S. A. CORPORATION

Accounting Entries for New Stock Issue

The U. S. A. Corporation, one of the largest public utility holding companies in America, had at October 1, 1928, an authorized capital stock of \$50,000,000, consisting of 500,000 shares of a par value of \$100 per share. In the company's general ledger was an account with "Capital Stock," showing a credit balance of \$50,000,000. There was also in the ledger an account entitled "Capital Stock in Treasury" with a debit balance of \$412,700. This represented 4,127 shares of stock at par. In fact, however, these 4,127 shares of stock were not in the treasury, for the stock had never been issued.

On October 5, 1928, at a special meeting of the stockholders of the company, it was voted to increase the capital stock of the company to \$100,000,000, this to consist of 1,000,000 shares of 7% cumulative preferred stock of a par value of \$50 per share, and of 1,000,000 shares of common stock of a par value of \$50 per share.

It was further voted by the stockholders that the 495,873 shares of common stock outstanding should be called in and for each share thereof of \$100 par value, there should be issued in its stead one share each of 7% cumulative preferred capital stock of \$50 par value and of common capital stock of \$50 par value. No additional subscriptions were made at this time.

³ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 318-328; Hatfield, *Accounting*, pp. 187-208; Dickinson, *Accounting Practice and Procedure*, pp. 127-133; Jackson, *Audit Working Papers*, pp. 113-118; Bell, *Auditing*, pp. 306-310; Federal Reserve Board, "Verification of Financial Statements," pars. 104-110.

The company desired to have accounts set up in the ledger with the authorized capital stock, which accounts would remain the permanent ledger accounts for capital stock. Accordingly, the accounting firm which served the company as auditor was asked to prepare journal entries to record properly the results of the stockholders' resolutions.

After giving proper consideration to the stockholders' resolutions, and discussing the matter with the comptroller of the company, the auditor prepared two journal entries as follows:

JOURNAL ENTRIES, OCTOBER 5, 1928

(1)

Unissued 7% Cumulative Preferred Capital Stock, 1,000,000 shares of \$50 par value	\$50,000,000.00	
Capital Stock, 500,000 shares of \$100 par value	50,000,000.00	
To 7% Cumulative Preferred Capital Stock Authorized, 1,000,000 shares of \$50 par value		\$50,000,000.00
Common Capital Stock Authorized, 1,000,000 shares of \$50 par value		50,000,000.00
To record the authorization of new stock in accordance with the stockholders' resolutions of this date, and to close off the Capital Stock account.		

(2)

Unissued Common Capital Stock of \$50 par value shares	\$25,206,350.00	
To Capital Stock in Treasury of \$100 par value shares		\$ 412,700.00
Unissued 7% Cumulative Preferred Capital Stock of \$50 par value shares		24,793,650.00
To record the new capital stock outstanding, and also unissued; also, to close off the Capital Stock in Treasury account.		

The comptroller of the U. S. A. Corporation felt that the journal entries prepared by the auditor were too involved, inasmuch as they were "composite entries." He admitted that the

entries shown above gave the correct resulting ledger accounts,¹ but he suggested instead the following entries, which he believed would be more readily understood by any one who might later peruse the books of account:

JOURNAL ENTRIES, OCTOBER 5, 1928

(1)

Unissued 7% Cumulative Preferred Stock, 1,000,000 shares of \$50 par value	\$50,000,000.00	
Unissued Common Stock, 1,000,000 shares of \$50 par value	50,000,000.00	
To 7% Cumulative Preferred Stock Authorized, 1,000,000 shares of \$50 par value		\$50,000,000.00
Common Stock Authorized, 1,000,000 shares of \$50 par value		50,000,000.00
To record the authorization of new stock in accordance with the stock- holders' resolutions October 5, 1928.		

¹ After the entries prepared by the auditor were posted, the accounts would appear as follows:

THE LEDGER ACCOUNTS
CAPITAL STOCK

10/5/28 J. E.	<u>\$50,000,000.00</u>	10/1/28 Balance	<u>\$50,000,000.00</u>
-------------------------	------------------------	---------------------------	------------------------

CAPITAL STOCK IN TREASURY

10/1/28 Balance	<u>\$ 412,700.00</u>	10/5/28 J. E.	<u>\$ 412,700.00</u>
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7% CUMULATIVE PREFERRED CAPITAL STOCK AUTHORIZED

10/5/28 J. E.	\$50,000,000.00
-------------------------	-----------------

COMMON CAPITAL STOCK AUTHORIZED

10/5/28 J. E.	\$50,000,000.00
-------------------------	-----------------

UNISSUED 7% CUMULATIVE PREFERRED CAPITAL STOCK AUTHORIZED

10/5/28 J. E.	<u>\$50,000,000.00</u>	10/5/28 J. E.	<u>\$24,793,650.00</u>
10/5/28 Balance	<u>\$25,206,350.00</u>	Balance	<u>25,206,350.00</u>

UNISSUED COMMON CAPITAL STOCK AUTHORIZED

10/5/28 J. E.	<u>\$25,206,350.00</u>
-------------------------	------------------------

(2)

Capital Stock, 495,873 shares of \$100 par value	\$49,587,300.00	
To Unissued 7% Cumulative Preferred Stock, 495,873 shares of \$50 par value		\$24,793,650.00
Unissued Common Stock, 495,873 shares of \$50 par value		24,793,650.00
To record the exchange of old issue capital stock for Preferred and Common Stock in accordance with the stockholders' resolutions, October 5, 1928.		

(3)

Capital Stock, 4,127 shares of \$100 . . .	\$412,700.00	
To Capital Stock in Treasury . . .		\$412,700.00
To close latter account as the stock has never been issued.		

To these entries, as prepared by the comptroller, the auditor replied as follows:

The entries as submitted by you were considered by us, but it was decided that they did not correctly set forth the facts. The first entry submitted by you would show an additional \$50,000,000 of Common Stock authorized (in addition to the \$100 par-value shares already outstanding), whereas actually the old Common Stock of \$100 par value was merely exchanged for the new Common Stock and Preferred Stock, and at no time could both stock issues have been authorized. As soon as the new issue became the authorized Capital Stock of the Company, the old issue was canceled.

The entries submitted by you obtain the final results desired, but it appeared to us in submitting our original entries that that method set forth the facts as they actually existed.

Upon receipt of this communication from the auditor, the comptroller instructed the head bookkeeper to prepare journal vouchers to record the results of the stockholders' resolutions in accordance with the auditor's entries first submitted.

Comment upon the desirability and the correctness of the procedure as outlined.

¹ See Hatfield, *Accounting*, pp. 196-198.

PROBLEM 63

THE JOHN ALBERT PIANO COMPANY

Treatment of Discount on Common Stock Acquired

The John Albert Piano Company, located in Beverley, Mass., manufactured and sold high-grade grand and upright pianos, player pianos, and piano repair parts, benches, etc. The business was started in 1880 as a single proprietorship; Mr. Albert's first investment was approximately \$50,000.

From 1880 to 1915, John Albert gave his entire time to the improvement of his product, and to the development of his business. The business was incorporated in 1905, and in 1915, when Mr. Albert retired from the active management of the company's affairs, the corporation had an authorized capital stock of \$5,000,000; of this authorized capital \$3,000,000 was common stock, and \$2,000,000 7% cumulative preferred stock. Both stocks were of a par value of \$100 per share. The preferred stock was also preferred as to assets, and was callable, in whole or in part, upon vote of the common stockholders, at \$105 per share; it did not carry voting rights.

When Mr. Albert retired in 1915, his son, Charles Jacobs Albert, became president; John Albert became chairman of the board of directors, which position he retained until his death early in 1921. After his father's death, C. J. Albert continued as president and general manager of the business; at December 31, 1924, the company had the following amounts of capital stock authorized, outstanding, and in the treasury:

	<u>Common</u>	<u>Preferred</u>
Authorized (shares of \$100 each)	\$3,000,000.00	\$2,000,000.00
Issued	3,000,000.00	1,500,000.00
Outstanding in hands of public	2,900,000.00	1,000,000.00
In treasury — par value	100,000.00	500,000.00
In treasury — cost and book value	70,000.00	400,000.00

The common stock was all held by the family and the friends of John Albert. At December 31, 1924, the company had also an earned surplus of slightly more than \$200,000.

From 1921 to 1924, inclusive, the company had not been suc-

cessful; annual losses had ranged from \$475,000 in 1921, to approximately \$60,000 in 1924. The accounts had been audited regularly by a firm of certified public accountants, and the annual reports rendered directly to the stockholders. The accountants believed that these losses were partly the result of general business conditions, but they had also pointed out in their several reports certain practices which they considered unsound, and which they believed showed an unconservative policy on the part of management.

At the annual meeting of stockholders, held late in February, 1925, great dissatisfaction was expressed with C. J. Albert's management of the company, and he was asked to resign from the presidency. Mr. Albert owned outright 10,000 shares of the common stock of the company, and still possessed sufficient influence with certain other common stockholders to assure to himself a bare majority control; however, he agreed to withdraw from the presidency and relinquish his control entirely on the condition that the company buy his holdings of common stock. This it was voted to do; the newly elected directors finally agreed to pay him \$100,000 in cash, and \$650,000 in the 7% cumulative preferred stock. This was provided for by proper resolution, voted at a regular meeting of the directors.

The charter of the company, issued under the statutes of the Commonwealth of Massachusetts, gave it the right "to purchase, hold and reissue the shares of its capital stock"; the charter also provided that "the preferred stock shall be issued as and when the Board of Directors shall determine." Accordingly, the 10,000 shares of common stock owned by C. J. Albert were acquired and the preferred stock issued; the common stock was not canceled but was held in the treasury for future issue. The discount on the capital stock acquired was credited to a capital surplus account.

The new management, as soon as possible, made a thorough survey of the company's affairs. Subsequently one plant was condemned and dismantled at a total capital loss of \$150,000 and \$50,000 of old accounts were declared worthless and were written off. Both the capital loss and the loss from bad debts were offset against the capital surplus set up at the time of acquiring

C. J. Albert's common stock at a discount. At December 31, 1925, the balance of the capital surplus account was transferred to the general surplus.

This was the situation when the accountants, early in 1926, began their audit of the company's accounts for the fiscal year ended December 31, 1925. The auditor for the company was requested to consider, (a) whether it was legal for the company to acquire the common stock in the manner outlined, (b) whether the rights of the holders of the preferred stock were prejudiced by the action, and (c) whether the surplus was properly stated.

What decisions should the auditor reach?

PROBLEM 64

BROWN LEATHER COMPANY

Audit of Employees' Stock Subscriptions

The Brown Leather Company, manufacturer of sole and upper leathers for shoes, was located in St. Louis, Mo. The company employed approximately 1,500 people, and did an annual business of approximately \$6,500,000. There had always been cordial relations between the management and the employees, and there had never been labor troubles of consequence since the organization of the company; various methods had been worked out by joint committees of the management and employees whereby general living conditions might be improved, employees might become owners of their homes, and savings might be encouraged.

In keeping with this spirit, the company decided in January, 1926, to provide for its employees a plan whereby they might become owners of a reasonable amount of the preferred capital stock of the company; the plan adopted was similar to those already in use by a number of leading corporations.¹ By this

¹ The employees' stock subscription plan of the Bethlehem Steel Corporation, 1925 series, was as follows:

plan each employee might obtain a limited number of shares, based upon his salary and term of service, of the company's 7% cumulative preferred stock; the subscription price was fixed at \$97 per share, and all employees who had been in the employ of

BETHLEHEM STEEL CORPORATION
EMPLOYEES SAVING AND STOCK OWNERSHIP PLAN

[1925]

February 2, 1925.

To the Employees of

Bethlehem Steel Corporation and its Subsidiary Companies:

Pursuant to arrangements made between the undersigned as Trustees and Bethlehem Steel Corporation, the opportunity is offered to the employees of the Corporation (each term includes for all purposes hereunder its Subsidiary Companies) to purchase shares of its Seven Per Cent Cumulative Preferred Stock (of the par value of \$100 each) upon the following terms and conditions:

1. **PURCHASE PRICE.** The purchase price is One Hundred Dollars (\$100) per share.
2. **ELIGIBILITY.** Any employee now in the service of the Corporation may apply for shares.
3. **APPLICATIONS.** Applications for stock to be purchased under this plan shall be made on the forms furnished by the Trustees, and should be delivered to the Cashier who pays the wages or salary of the applicant before March 3, 1925.
4. **NUMBER OF SHARES AND ALLOTMENT.** The maximum number of shares that may be applied for by any employee is one share for each full four hundred dollars (\$400) of wages or salaries and other compensation for services paid by the Corporation to such employee for the calendar year 1924; except, that in case of any one employed after January 1, 1924, his or her average earnings during the period of employment up to the date of application shall be adjusted to an annual basis for the purpose of this paragraph. Any employee may at his or her option apply for less than the maximum number of shares. The Trustees reserve the right in their absolute discretion to reject any application or to allot to any employee less than the number of shares applied for.
5. **NOTICE OF ALLOTMENT.** Notice of the number of shares allotted upon each application will be mailed or delivered by the Trustee to the applicant as soon as possible after March 3, 1925, and each such applicant to the extent that stock is so allotted shall become the Purchaser thereof under this Plan.
6. **PAYMENT FOR STOCK.** The purchase price of stock allotted upon any such application may be paid in installments to be deducted from the wages or salary of the Purchaser on each pay day. The first deduction will be made on the first pay day in April, 1925. Each installment must be at least \$1.00 per share of stock allotted in the case of Purchasers paid weekly, or at least \$2.00 per share in the case of Purchasers paid semi-monthly or bi-weekly, or at least \$4.00 per share in the case of Purchasers paid monthly. In any case at the option of the Purchaser the installments to be deducted may exceed the minimum amounts specified, provided that the amount of each installment (except the final installment) must be in even dollars and that the total deductions authorized on account of stock purchased under this plan and under any similar plans (past or future) shall not exceed 25% of the estimated wages or salary of the Purchaser (unless the Trustees approve). Within such limitations any Purchaser may at any time increase or decrease the amount of each such installment by written notice to the Cashier who pays the wages or salary of the Purchaser. The deductions will be made in each case by such Cashier. Any Purchaser may at any time make additional cash payments in even dollars to such Cashier to be applied on account of such purchase price, and interest as provided in Paragraph 7 hereof, or may pay the unpaid balance thereof in full. The deductions and additional payments, if any, will be forwarded promptly to the Trustees, and credited by them as payment on account of such purchase price and interest at the end of the month in which made.
7. **INTEREST ON DEFERRED PAYMENTS.** Interest at the rate of five per cent (5%) per annum will be charged on the unpaid balance of the purchase price of stock purchased under this Plan from April 1, 1925, until payment therefor in full shall be completed.
8. **DIVIDENDS.** Until the purchase price of all the stock purchased hereunder by any Purchaser and interest on deferred payments as above provided has been paid in full all dividends paid on such stock on July 1, 1925 (the first dividend date after April 1, 1925) and thereafter will be paid to the Trustees for the account of such Purchaser and immediately credited by them as payment on account of such purchase price and interest.
9. **DELIVERY OF CERTIFICATES.** When the purchase price of all the stock purchased hereunder by any Purchaser together with interest on deferred payments as above provided shall have been paid in full, stock certificates will be delivered to such Purchaser and thereafter all dividends will be paid direct to him or her.
10. **SPECIAL BENEFITS.** As an incentive to the Purchasers of stock hereunder to complete their purchase agreements and to retain the purchased stock while they shall remain in the service of the Corporation the Corporation has agreed to pay to or for the account

the company for at least one year were permitted to subscribe for 1 to 5 shares each. The company had already purchased the shares in the open market, so that under the stock subscription

of each Purchaser in January of each year for five (5) years, commencing with January, 1926, for each share of stock purchased by him or her hereunder, a special bonus as follows:

In January 1926	.....	\$1.00 Per Share
" " 1927	.....	2.00 " "
" " 1928	.....	3.00 " "
" " 1929	.....	4.00 " "
" " 1930	.....	5.00 " "

provided in each case that the Purchaser shall have been continuously in the employ of the Corporation during the preceding calendar year, and that his or her purchase agreement shall not have been cancelled but is being duly performed, or, if payment therefor shall have then been completed, that the purchased stock shall not have been sold. Suspension of employment temporarily by reason of temporary disability or lay-off will not be treated as interrupting the continuous employment of the Purchaser during the preceding calendar year for the purpose of this paragraph, provided the Purchaser shall resume his or her work when the cause of suspension is removed. Until the purchase price of the stock purchased by any Purchaser and interest on deferred payments as above provided shall have been paid in full the special payments above specified will be paid to the Trustees for the account of such Purchaser and credited as payments on account of such purchase price and interest at the end of the current month. Thereafter for the remainder of the five-year period the special payments will be made directly to the Purchaser.

11. CANCELLATION OF PURCHASE AND TERMINATION OF EMPLOYMENT. Any Purchaser may cancel his or her purchase agreement at any time prior to the payment in full for all stock purchased by him or her hereunder by notice in writing to the Trustees of his or her election so to do. In case the employment of any Purchaser by the Corporation is terminated (otherwise than by death, total disability or retirement on pension) the purchase agreement of such Purchaser hereunder shall automatically be cancelled.

If any such purchase agreement shall be cancelled as above provided or shall be cancelled by the Trustees in accordance with the provisions of paragraphs 12, 13 or 15 hereof, the Trustees, at their option, may either

(a) deliver to the Purchaser within thirty (30) days after such cancellation a certificate for the number of full shares for which the payments made by or for the account of such Purchaser (including amounts received by the Trustees from wages or salaries, dividends and special benefit payments after deducting interest on deferred payments) shall have been sufficient to pay in full, and also pay in cash to such Purchaser, in lieu of fractional shares, any balance of such payments, with interest on such balance at the rate of five per cent (5%) per annum; or,

(b) pay to the Purchaser within thirty (30) days after such cancellation an amount in cash equal to the payments made by or for the account of such Purchaser (including amounts received by the Trustees from wages or salaries but excluding dividends and special benefit payments and without deducting interest on deferred payments) with interest thereon at the rate of five per cent (5%) per annum from the date of each such payment; or,

(c) permit the Purchaser within thirty (30) days after such cancellation to pay the balance of the purchased price of the purchased stock with interest on deferred payments as above provided and thereupon deliver to him or her the certificate for the stock so purchased.

12. DEATH, DISABILITY, OR RETIREMENT ON PENSION. In case of the permanent disability or retirement on pension of any Purchaser, he or she, or, in case of death, the beneficiary (if one be designated as hereinafter provided) or his or her estate (if no beneficiary be designated), shall have the option, to be exercised by notice in writing to the Trustees, within thirty (30) days after the date of such permanent disability, retirement or death, either (a) to continue the purchase agreement with all its obligations hereunder in full force and effect, provided arrangements satisfactory to the Trustees shall be made for the payment of the unpaid installments of the purchase price and interest as above provided, or (b) to cancel the purchase agreement and at his, her or their option either to receive certificates for stock and cash as provided in clause (a) of Paragraph 11 hereof, or to receive cash only as provided in clause (b) of said Paragraph 11. In case any such Purchaser, beneficiary or estate shall elect to continue the purchase agreement as provided in the foregoing clause (a) of this Paragraph 12, such Purchaser, beneficiary or estate shall be entitled to the special benefits payable in accordance with the provisions of Paragraph 10 hereof during the remainder of the five-year period therein specified (without complying with the requirements as to employment) so long as such purchase agreement is being performed or if payment therefor has been completed so long as such stock shall not have been sold. A distribution of such stock, however, incident to the settlement of the estate shall not be deemed a sale for the purpose of this provision.

plan the shares might be sold to the employees at any price desired, and still be issued to them as fully-paid and non-assessable shares. The stock is listed on the New York Stock Exchange;

In case, upon permanent disability, retirement on pension or death, any such Purchaser, beneficiary or estate shall fail to exercise the foregoing option within said period of thirty (30) days the Trustees may cancel the purchase agreement in which case the provisions of Paragraph 11 hereof shall apply.

13. **SUSPENSION OF EMPLOYMENT.** A Purchaser whose employment is suspended because of temporary disability or lay-off may at his or her option either pay the regular installments of the purchase price (equal in amount to the deductions from wages and salaries theretofore authorized) in cash to his or her Cashier or may suspend such payments during such suspension of employment; provided, however, that if such payments shall at any time be in arrears for a period longer than three (3) months (or such additional period as the Trustees may from time to time fix), the Trustees may at their option cancel the purchase agreement, in which case the provisions of Paragraph 11 hereof shall apply.

14. **BENEFICIARY IN CASE OF DEATH.** Each Purchaser may name in his or her application as beneficiary the person who, in the event of the Purchaser's death, will be entitled to receive all sums payable hereunder and certificates for the stock purchased hereunder (subject to the conditions hereof) which would otherwise be payable or deliverable to the Purchaser's estate, and upon satisfactory proof of such death all such sums and certificates shall be paid or delivered to such beneficiary. Every Purchaser is urged to name such beneficiary. A purchaser may at any time substitute another beneficiary for the one previously named by written notice to the Trustees, which may be delivered to his or her Cashier for forwarding. In case the Purchaser shall fail to name such beneficiary or in case the beneficiary so named shall die before the Purchaser and the Purchaser shall fail to name a substitute such sums shall be paid and certificates delivered to the estate of the Purchaser.

15. **SALE, ASSIGNMENT, ETC.** The rights vested in the Purchaser under the purchase agreement are strictly personal and except with the express written assent of the Trustees neither said rights nor any interest therein shall be subject to sale, pledge, assignment or transfer by the Purchaser, or his or her executors, administrators or assigns, at any time or in any manner whether by voluntary act of the Purchaser or otherwise, nor shall they be subject in any way to attachment, execution or sale for any of the employee's debts or liabilities; and if any sale, pledge, assignment or transfer thereof is made or attempted, or if any attachment or execution is issued against the same the Trustees may at their option cancel the purchase agreement, in which case the provisions of Paragraph 11 hereof shall apply.

16. **NOTICE TO TRUSTEES.** Any notice in writing to the Trustees to be given by any Purchaser in accordance with any of the provisions of this Plan may be delivered to the Cashier who pays the wages or salary of the Purchaser with the same force and effect as if delivered to the Trustees in person.

17. **POWERS AND DUTIES OF TRUSTEES.** The Trustees shall have the power to pledge all shares of stock held for account of the Purchasers or any of them under this Plan as security for loans to be obtained by the Trustees for the purpose of paying the purchase price of the stock purchased by the Trustees and sold by them to the Purchasers hereunder, and also power to apply any or all moneys received by them in accordance with any of the provisions hereof to the payment of, or on account of, such loans or such purchase price.

The Trustees shall also have the power to vote upon all such stock for any purpose until it is fully paid for and the certificates therefor issued to the respective Purchasers.

All questions concerning this Plan, the applications and agreements to purchase and the interest of the Purchasers thereunder shall be decided by the Trustees, and their decision shall be final and conclusive.

The action of a majority of the Trustees shall be deemed to be the action of all the Trustees for all purposes hereunder.

Any Trustee may resign at any time and any Trustee may be removed by the Board of Directors of Bethlehem Steel Corporation at any time. In case of the resignation, removal or death of any Trustee a successor shall be appointed by said Board of Directors.

The Trustees shall receive no remuneration for acting as Trustees under this plan, and shall not be liable in any respect for any action taken or omitted hereunder except for wilful misconduct.

E. G. GRACE	H. S. SNYDER
H. E. LEWIS	F. A. SHICK
J. M. LARKIN	R. E. McMATH

Office and P. O. Address
of Trustees:
701 East Third St.,
Bethlehem, Pa.,

Trustees for Employees of Bethlehem
Steel Corporation and its Subsidiary
Companies under Employees Saving and
Stock Ownership plan,

over a period of years the price of the shares has ranged from \$94 to \$105 per share.

A special form of subscription blank was prepared, and approximately 900 separate subscriptions, for a total of 1,692 shares of capital stock, were received. The subscription blanks were placed in the custody of the treasurer, and were arranged by him alphabetically according to the operating and administrative de-

(Form 1)

APPLICATION FOR STOCK AND AGREEMENT TO PURCHASE 1925

To the Trustees for Employees of Bethlehem Steel Corporation and its Subsidiary Companies under Employees' Saving and Stock Ownership Plan:

Referring to the Employees' Saving and Stock Ownership Plan dated February 2, 1925, which is hereby made a part of this application and agreement, I hereby apply for *..... shares of the Seven Per Cent Cumulative Preferred Stock of Bethlehem Steel Corporation to be purchased at the price and upon the terms and conditions set forth in said Plan.

If and to the extent that stock shall be allotted to me as provided in said Plan I agree to pay therefor the full purchase price with interest, upon deferred payments as provided in said Plan and I hereby authorize and direct the Cashier who pays my wages or salary on each pay day after April 1, 1925, until such purchase price and interest shall have been paid in full, to deduct from the wages or salary then due to me the sum of \$.....** per share of stock so allotted to me, or such other sum as I may from time to time elect to have deducted by notice in writing to you or your successors in accordance with the provisions of Paragraph 6 of said Plan. I further authorize and direct said Cashier to pay the amounts so deducted to you or your successors as Trustees under said Plan. I further authorize and direct you and your successors to collect all dividends paid on the shares of stock which shall be allotted to me and all special benefit payments to which I shall become entitled in accordance with the provisions of Paragraph 10 of said Plan, until such purchase price and interest shall have been paid in full and to credit the amounts so deducted from my wages or salary and such dividends and special benefit payments as payments on account of such purchase price and interest, all as provided in said Plan.

I hereby designate.....*** who may be addressed at Street, City of....., State of....., as the person to whom, in the event of my death, you and your successors, as such Trustees, are to pay all sums payable under said Plan and deliver certificates for the stock purchased by me (subject to the conditions of said Plan) which would otherwise be payable or deliverable to my estate, all in accordance with the provisions of Paragraph 14 of said Plan.

Dated:, 1925.

(To be filled in by Trustees)

Application Received.....	.....	Signature (first name in full).....
No. of Shares Allotted.....	.....	.....
Deduction per Share.....	.....	.....
Total Deduction.....	.....	.....
Weekly Bi-Weekly Semi-Monthly Monthly	.....	Plant where Dept. Symbol and employed Number
Average Earnings 1924 \$.....	.....	.....
Maximum No. Shares.....	.....	.....
1924 Series:	.....	.....
No. of Shares Allotted.....	.....	Mailing Address (Street).....
Total Deduction \$.....per.....period	.....	.....
	.....	(Town or City and State).....

* Here insert the number of shares desired, which must not be greater than the number you are entitled to apply for as explained in Paragraph 4 of the Plan.
** This must be at least \$1.00 per share if you are paid weekly or at least \$2.00 per share if you are paid once a month, but it can be as much larger in each case as you wish, subject to the limitations contained in Paragraph 6 of the Plan.
*** Here you may insert name of your wife or other relative or any other person. If practicable you should name some person or persons more than 21 years old.

When subscriptions were paid in full and the stock issued, or when subscriptions were canceled in accordance with the subscription agreement, the above entry was reversed for the number of shares issued or canceled.

The method provided for the payment of the subscriptions was as follows :

(a) Beginning with the first week in April, \$1 weekly for each share of capital stock subscribed would be deducted from the employee's wages, the deduction being marked on the employee's pay envelope. These weekly amounts would be debited to Wages and credited to Employees' Payroll Deductions; the latter account is a controlling account, summarizing the weekly wage deductions for the 900 subscribers. Each payroll sheet contained a special column for "Deductions" in which these amounts were entered, and from which the postings were made to the employees' accounts and to the control in the general ledger.

(b) Any employee could make cash payments on his subscription; in fact he could pay in full for his stock at the time of subscription if he desired. These amounts would be debited to Cash and credited to Employees' Cash Payments. Receipt books, in which were duplicate receipts serially numbered, were used for these payments; the original receipt, which was perforated, was given to the employee, while the duplicate remained in the bound receipt book. From these duplicates the postings were made to the employees' accounts; a total of the month's duplicates is prepared and this sum is posted to the general ledger controlling account.

(c) Dividends at the rate of \$1.75 quarterly would be paid on the stock; each employee would be credited quarterly for the dividend on his shares of stock purchased. Dividends on the 7% cumulative preferred stock were payable February, May, August, and November 15, to stockholders of record twenty days earlier. When the stock was issued to the employee subscribing for it, the dividend checks would be mailed to him as in the case of any other stockholder.

(d) As a special inducement to the employees to hold their stock, the company agreed to pay a special bonus each year, up to five years, that the stock was held. This bonus would be \$1 per share the first year, \$2 per share the second year, and so on, for five years; after five years the employee would receive only the regular quarterly dividend on the stock. The total amount of the bonus each year would be covered by a resolution in the minutes of the board of directors;

the amount would be debited to Surplus and credited to Employees' Special Benefit Payments—the individual employees being also credited for the amount applicable to their shares.

(e) Interest was charged monthly on the unpaid balances at the rate of 6% per annum; the total was debited to Interest on Employees' Subscriptions and credited to Interest Income—the individual employees being also debited for their proper share.

A ledger card was prepared for each employee.² This gave, at the top of the card, the name and address of the subscriber, the number of shares subscribed, and the weekly deduction to be made from the payroll. The card was then divided into five vertical sections, one for each of the four methods of payment set forth above and for the interest charges; each of these sections was, in effect, a subsidiary ledger account, the five sections for the 900 subscriptions being controlled by the five general ledger accounts, as follows:

- Employees' Payroll Deductions
- Employees' Cash Payments
- Employees' Dividends
- Employees' Special Benefit Payments
- Interest on Employees' Subscriptions

The company permitted an employee to cancel his subscription at any time he desired. The total credits, as shown by the employee's ledger card, less the interest charged on the account, was paid to the employee in cash; a receipt was obtained from the employee, and this was filed with the employee's original subscription blank. If a subscription was canceled the employee was allowed interest on his payments at the rate of 5%; the dividend and special benefit credits, and the interest charges, were reversed in the accounts monthly for all subscriptions canceled during that month.

Likewise, when employees paid their subscriptions in full, the shares of stock were issued and a receipt was obtained from each employee for the stock delivered. The receipts were attached to the original subscription blank, and became a part of the permanent accounting record.

² The card used for this purpose was 8 by 11 inches in size, and is shown on page 315.

When subscriptions were canceled, or were paid in full and the certificates of stock issued, the employees' subscription blanks together with their ledger cards were removed from the active files and were placed in a permanent file; the canceled subscriptions were filed together alphabetically by departments, while those which had been paid in full and the stock issued were similarly filed together. Prior to December 31, 1926, subscriptions for 67 shares of stock had been canceled; 33 shares of stock had been fully paid and the stock issued to the subscribers. Receipts were in the possession of the treasurer to substantiate these transactions.

On December 31, 1926, the close of the company's fiscal accounting period, the general ledger accounts relating to the employees' stock subscriptions had the following balances:

<u>Name of Account</u>	<u>Debit Balances</u>	<u>Credit Balances</u>
Employees' Applications on Stock Ownership Plan . .	\$154,424.00	
Interest on Employees' Subscriptions	3,483.00	
Employees' Payroll Deductions		\$ 62,088.00
Employees' Cash Payments		1,576.00
Employees' Dividends		8,358.00
Employees' Special Benefit Payments		1,592.00
Allotment of Stock		154,424.00

Comment briefly upon the following:

(a) Is the method of accounting for employees' stock subscriptions satisfactory? If not, wherein should it be changed? Be definite in any suggestions for change in the method now used.

(b) In auditing the company's accounts, for the purpose of certifying its balance sheet, what verification should be made of these accounts? Would the verification vary if a detailed report on the audit were to be submitted instead? Describe and discuss in detail.

(c) How should the above seven accounts be reflected in the company's balance sheet? Give reasons.

PROBLEM 65**THE DUNDEE MANUFACTURING COMPANY****Basis of Valuing No-Par Treasury Stock**

The Dundee Manufacturing Company, organized in 1910, had an authorized capital stock of \$5,000,000, to consist of 50,000 shares of common stock of a par value of \$100 each. By the close of 1910 all of this stock had been issued, and was outstanding in the hands of the public. From 1910 to 1920, the company made reasonable profits, the major portion of which was distributed to the stockholders as cash dividends. During the latter part of 1920, and during 1921, the company was obliged to take heavy losses on inventories and purchase commitments; the balance sheet of the company at December 31, 1921, showed a deficit of \$1,750,220.

At the annual meeting of the stockholders, held during the latter part of January, 1922, it was accordingly voted to reorganize the company; the capital stock of par value was surrendered, and in its place there were issued 100,000 shares of common stock of no-par value. The new capital stock was set up in the ledger at an aggregate amount of \$3,249,780; this represented the net proprietorship of the corporation at December 31, 1921.

During 1922 an additional 100,000 shares of the stock was sold; the price per share ranged from \$28 to \$37.50, depending upon the market price of the stock when sold. At December 31, 1922 the capital stock account showed a total credit of \$6,107,800, this amount representing the proceeds of the 200,000 shares of no-par stock outstanding.

Sometime during the latter part of 1922, the treasurer was authorized by resolution of the board of directors to purchase "at the market" up to 10,000 shares of the company's capital stock; the company had under consideration an employees' stock ownership plan under which this stock would be sold to those employees desiring to subscribe for it. Accordingly, the treasurer purchased in the open market stock to the extent of 6,000

shares; the price per share has ranged from \$27.50 to \$30. The stock as purchased has been entered in the books at the cost of acquiring it, and has been charged to the general ledger account, Treasury Stock.

At the close of the fiscal year, December 31, 1922, and in anticipation of preparing the final accounts for audit and certification, the question had arisen concerning the value per share at which the treasury stock should be reflected in the published accounts. The comptroller had considered carefully both methods of valuing such treasury stock for balance sheet purposes;¹ he found himself unable to agree that the "original sale price" method was the one most to be desired, or as best recording the actual facts. He maintained that any method which books treasury stock without par value at an amount based upon a price per share in excess of the average price results in an impairment of capital. The method also implies, he stated, the assignment of different values to shares of stock which the law prescribes shall be equal in all respects and in all cases.

As a practical matter, the comptroller further believed that in many cases the original-sale-price method is quite impossible of application. For illustration, one shareholder may have acquired

¹ These methods are clearly set forth in Conyngton's *Corporation Procedure*, Book III, Ch. XI, pp. 1125-1126, as follows:

"The principle followed in the account for par-value treasury stock was that such stock should be carried on the books at par in order that it might properly be offset against the total issued stock (which is also carried at par), because the repurchase of a corporation's own stock is in reality a reduction of the capital, at least temporarily. Applying this same principle to no-par stock, treasury stock should be entered on the books at the price at which it was originally credited to the Capital Stock account.

"Stock of no-par value, like par-value stock, may be repurchased by the issuing corporation at a price differing from that at which it was originally issued. If it is repurchased above that price, the difference will be a reduction in the surplus available for dividends, and will be debited to Surplus account just as in the case of par-value stock. It is especially necessary in the case of no-par stock to exercise great care to see that the contributed capital is never encroached on in distributions of surplus through dividends; the exact entries of the purchase price of treasury stock are vital on this account in order that the Surplus account as well as the Capital Stock account may reflect the true conditions.

"No-par treasury stock repurchased at less than its original sale price must, in the same way, be carried on the books at the original sale price in order that the Capital Stock account may, after the balance in the Treasury Stock account has been offset against it, show the amount originally received for the stock which is outstanding. The difference between the original sale price and the repurchase price, or discount at which it was rebought, may, as in the case of par-value stock, be credited to Contingent Profit on Treasury Stock, or may be considered as creating a paid-in surplus.

"The above principle of entering treasury stock at the value at which it was originally issued is in greatest favor, but there is another theory which has some adherents. If different blocks of no-par stock are issued at various prices, the Capital Stock account at any time divided by the number of shares then outstanding gives the average issuance price of all stock. . . . There are those who favor bringing treasury stock into the books at this figure. Since, however, more of the unissued stock might later be sold at a price which would result in still another average, this method does not stabilize book entries as it might seem to do; and whether such average values should be used in the determination of the effect upon surplus of the repurchase of stock or whether for this purpose one should use the price at which the particular shares reacquired were issued is a debatable point which will probably not be finally settled until the courts pass on some case of impaired capital."

his stock at several different times and at varying prices; he resells a portion of his holdings to a third party, and after numerous other transfers, perhaps, some of this is purchased by the issuing corporation. It is quite impossible in such a case for the corporation or for any one else to "determine either the identity or the original sale price of the shares transferred."

The comptroller therefore believed that the "average sale price" of all shares outstanding was the correct and equitable basis for the valuation of no-par value treasury stock, and he has prepared his accounts accordingly.² It was his opinion that, for balance sheet purposes, such treasury stock requires revaluation upon each succeeding sale of unissued stock at a price other than such average price; the basis for such revaluation would be the new average price per share for the total number of shares issued.

When the independent auditor took up the annual verification of the accounts he was requested to give his opinion on the matter. The auditor stated that, in the sense in which the term "treasury stock" is generally used, there really was no such thing as no-par value treasury stock. The amount credited to the capital stock account "constitutes a fund set apart and devoted to the corporate uses and the security of the creditors. . . .";³ the amount received from the issue of the no-par stock must not be reduced by the temporary acquisition by the company of its own shares. Such stock may be repurchased only and when there is sufficient accumulated surplus against which the cost may be charged. The net result, therefore, of a company purchasing its own no-par value shares is merely to decrease the number of shares outstanding in the hands of the public, and to increase proportionally the per-share book value of the remaining shares outstanding.⁴ Similarly, the Surplus account is reduced by the cost of the stock so reacquired; in case the shares are again sold the total amount realized will be credited back to Surplus.

Since the net proprietorship of a corporation, continued the

² The preliminary statements of earnings and financial position, although probably subject to certain adjustments, showed net profits of approximately \$480,000 for the fiscal period ended December 31, 1922.

³ *Smith v. Dana*, 77 Conn. 543. The court also stated that "its dedication is irrevocable, and it must ever remain a sum held in trust for creditors, unless some judicial or other process authorized by legislation intervenes."

⁴ The contra of this principle, that is, where a stock dividend is declared on stock of no-par value, has already been generally recognized; see, for example, answers III and IV in the American Institute of Accountants questionnaire entitled "Stock, Dividends on Non-Par Value Stock" (see pp. 320-325).

auditor, or that portion of it represented by the common stock, is composed of the capital stock and net surplus combined, the ultimate effect on the proprietorship is the same when the cost of reacquiring the stock is charged against Surplus as if it were deducted from the Capital Stock account. Furthermore, there is no harm, for statistical purposes, in recording the purchased stock in a separate account in the ledger. However, when the no-par value Capital Stock account has once been established, no subsequent repurchase of the issued stock should be permitted to reduce the credit to Capital Stock.⁵

Discuss the soundness of the above views, and determine how the no-par value treasury stock should be reflected in the accounts to which the auditor will certify.

PROBLEM 66

AMERICAN INSTITUTE OF ACCOUNTANTS

Stock Dividends on No-Par Value Capital Stock

The American Institute of Accountants, one of the four great national accounting organizations in the United States,¹ maintains at national headquarters, 135 Cedar Street, New York City, a Bureau of Information which endeavors to answer questions and obtain information for members and others who may request it. One method adopted by the Bureau is to send a question, which has been submitted to it, to a number of leading practicing accountants, and then to send these answers to the party seeking the information; neither the name of the inquirer nor the names of those furnishing the information are known to any one except the Institute's Bureau of Information.

⁵ Some four years after this, the fundamental principles involved in this proposed treatment of treasury stock of no-par value were splendidly set forth by P. F. Brundage, "Treatment of No-Par Value Stock in New York, New Jersey, and Massachusetts," *The Journal of Accountancy*, Vol. XLI (April, 1926), pp. 241-256. Since the appearance of the above article other writers have made more or less reference to the treatment set forth; in some cases, however, it is apparent that their concept is based largely upon Mr. Brundage's discussion (see, for example, Robbins, *No-Par Stock*, pp. 153-162).

¹ The American Association of Public Accountants was organized in 1887; in 1916 the character of the organization was changed somewhat, and the name was changed to American Institute of Accountants. The American Association of University Instructors in Accounting was organized in December, 1916; the National Association of Cost Accountants was organized in September, 1919, and the American Society of Certified Public Accountants during 1921. Of course, various other accounting organizations exist within industries and trade groups; also, nearly every state has its state Society of Certified Public Accountants. All of these organizations have made their contribution to the development and advancement of accountancy within the United States.

Some of these questions and replies are of such general interest to the accounting profession at large that they are published by the Bureau of Information for the benefit of all. One such publication related to stock dividends on no-par value capital stock; both the question and the seven replies received are reproduced herewith:

QUESTION

When a stock dividend is declared in the case of a stock having par value, it is clear that the Surplus account will be reduced and the Capital Stock account increased by an amount equal to the number of shares issued as a stock dividend multiplied by the par value thereof.

In the case of a stock dividend declared in no-par capital stock, what amount, if any, should be transferred from the earned Surplus account to the stated value of the no-par capital stock?

ANSWERS

I

A stock dividend declared in no-par capital stock should read to the effect that a dividend of blank dollars per share is payable in stock. At the date of payment a corresponding amount will be transferred from Earned Surplus to Capital, thereby reducing the available earned surplus for cash dividends and accomplishing one of the main objects of a stock dividend. The amount of surplus so transferred would, of course, be optional with the board.

II

Our opinion must be given with certain reservations because the state in which the corporation operates is not supplied, but generally speaking, in absence of action by the directors fixing the dollars per share or amount to be transferred there would be a choice of two ways: one, the number of shares included in the dividend times the stated value per share, or that percentage of the stated or of the actual capital which the number of shares of the dividend bears to the number of shares previously outstanding.

III

Where a company is incorporated in a state requiring no stated value to be carried of no-par value stock, Surplus account might be taken as representing the value or equity of such stock, and only a memorandum Capital Stock account, without values, need be carried. In this case, no transfer would be made and notation only of the dividend and the corrected number of shares outstanding would be necessary.

As a general rule, however, companies incorporated with no-par value stock have on their books a Capital Stock account for such stock in the amount that the assets acquired were in excess of the total of liabilities

and the par value of preferred stock issued or at least a proportion of such excess. In such instances where no stated value is required, no transfer from Surplus would be necessary.

Where, however, the certificate of incorporation calls for a stated capital of so much per share outstanding, a transfer of that amount times the number of shares distributed as a dividend should be transferred to the already opened Capital Stock account. This account would then show the total shares outstanding at the stated value per share.

Again, if the certificate of incorporation calls for a round amount of stated capital and not a per share value of stock outstanding, this round amount would appear on the books as the Capital and would not be altered by a transfer upon the payment of a stock dividend of no-par value shares, unless with that end in view the charter was altered, in which case a corresponding figure would be transferred from earned surplus.

IV

A stock dividend on no-par value stock is in itself merely a means of increasing the number of outstanding shares. Such a dividend, if coupled with the capitalization of a part of the earned surplus, appears as reasonable a proceeding as the declaration of a stock dividend on a par-value stock. The transfer to capital account of a portion of the surplus could probably be accomplished by a resolution of the directors, but this is a legal question concerning which state laws may vary and upon which one should obtain competent legal advice.

V

The usual method followed in declaration of stock dividends is for the board of directors to pass a resolution containing about the following:

"... to stockholders of record of(date).....a dividend of% payable in the Common Capital Stock of this Company to be issued at par." Quite frequently, the total amount to be distributed is named in place of or in addition to the per cent.

It would seem that if there were a stated value per share of the no-par capital stock, that if a stock dividend were then declared and that if the resolution provided for distribution of a given number of shares of stock without mention of the amount of money which those shares represented, then the transfer from surplus to the stated value of the no-par common stock would be the stated value per share multiplied by the number of shares distributed. However, the query arises why a corporation should desire to distribute a stock dividend declared in no-par stock unless it also desired to sell additional shares to obtain new capital and the stock dividend is resorted to in an attempt to equalize equities as between the old shareholders and the new shareholders in the event the latter should buy shares at a lower price than the known or assumed true value of the stock.

The differences in no-par stock laws of different states and the doubtful points involved in their interpretation are so great and the entire

subject of no-par stock is so beset with uncertainty and opportunities for transgressing both moral and economic laws, that we are loath to answer this abstract question by any statement of general application. All of the facts involved in and surrounding the proposed action should be known before deciding upon either the propriety of the stock dividend itself or the stock-keeping entries involved thereby.

VI

I think I should first state that my actual experience with corporations having "no-par value common stock" has been somewhat limited, and I, therefore, feel that perhaps many of the practical questions which may have come up with some other accountants, who have had a larger experience in this respect, have not yet arisen in my practice.

I find on looking through my library that my copy of *Corporation Procedure*, by Conyngton, Bennett, and Pinkerton, states on pages 1152 and 1153, that "when a stock dividend is payable in stock without par value, the only entry required on the general books is one indicating the number of shares thus disposed of" and that no change is made in the amount of the Surplus account or of the Capital Stock account.

I find, however, on looking at the *Journal of Accountancy* for December, 1920, on page 459, that Mr. Finney, editor of the students' department, furnished as a part of the answer to the question therein contained the following statement:

"The account with stock without par value should be credited with only those amounts actually paid in on the stock, and with any surplus transformed into fixed capital by action of the directors, such action being analogous to the declaration of a stock dividend."

Since receiving your inquiry, we have had quite a discussion in the office on your question, and we have come to the conclusion that we agree with Mr. Finney rather than with Mr. Conyngton, *et al.*

My reasoning is in this manner:

I have always assumed that the real purpose of a stock dividend was to transfer from the Surplus account to the Capital account an amount which, so far as possible, would increase the Capital account to a sufficient amount to represent approximately the actual capitalization, or an amount which fairly represented the capital which the corporation needed to carry on its business.

If, in the case of declaring a stock dividend of no-par-value stock, it is contended that no change is made in the Surplus account, it leaves the corporation where it cannot take out of the Surplus account, which is available for dividends, an amount to be added to permanent capital, and this disability prevents withdrawing the amount to a position where it will not be subject to the payment of dividends.

If, however, a cash dividend is declared and the amount of this cash dividend is paid in for new stock, there is no argument against adding the price that the company receives for the new stock to the Capital Stock account.

This procedure would have exactly the same effect as transferring a similar amount from the Surplus account to the Capital account and issuing the same number of shares as a stock dividend except that, in the latter case, the stockholders would not be subject to a surtax on the dividend at the time the dividend was declared, but would defer the payment of the tax until the stock received as a dividend was realized upon in cash by them.

Under these circumstances, it would seem entirely obvious that a corporation having no-par value common stock not be deprived of its privilege of investing permanently in the capital of the company accumulated earnings which were actually needed in the conduct of the business and which the directors felt it would be for the interest and safety of the business to have designated as Capital instead of as Surplus. As I see it, there is no other means of accomplishing this except by declaring a stock dividend, unless a cash dividend is paid to the stockholders and then paid back to the company for new stock.

We have also studied the New York State law regarding no-par-value stock and thus far have been unable to find any requirement of the law which prohibits the payment of a stock dividend.

It is, therefore, our conclusion and opinion that in a case of this kind, we should recommend to our client that a stock dividend be declared, that the amount of dividend decided upon be transferred from the Surplus account to the Capital account, and that the requisite number of shares be added to the outstanding stock. We should expect, of course, to call in the old stock certificates and exchange them for new certificates, which would show the total shares of stock outstanding after the stock dividend.

I presume the question arises, if this is done, as to how many shares should be issued to cover the amount which it was decided to transfer to Capital. As you have not asked this question, I will not attempt to answer it except to say that I should judge this might depend very largely upon the circumstances in the case of each corporation and what the directors considered to be the wisest course under those circumstances which might exist.

VII

The question has been asked what amount, if any, should be transferred from the Earned Surplus account when a stock dividend is declared on no-par-value capital stock.

The question of the values to be set up for no-par capital stock is one that is subject to a great many interpretations. In the first place, no-par capital stock is quite frequently issued without any amount being paid in therefor, either in cash or in other property. The real value behind each share of no-par stock is the total of the capital stock account (if any is set up) plus the total Surplus account divided by the number of shares of no-par stock issued. If a stock dividend is issued in no-par stock, the total of these two accounts remains unchanged and the value of each

share of no-par stock is reduced corresponding to the increase in the number of shares brought about by such stock dividend declaration.

It would, therefore, appear to be necessary that the directors in declaring a stock dividend on no-par stock should state in their resolution that so much value should be taken from the Surplus account, transferred to the stated Capital Stock account, to be divided in the issuance of no-par stock of a certain number of shares at a fixed amount, thus making capital out of what was formerly surplus.

This would have the effect of taking out of this Surplus account an amount that would otherwise be subject in the discretion of the directors for distribution as cash dividend.

In declaring a stock dividend on no-par capital stock, no distribution in money value could certainly be considered unless that amount was stated, and under the new revenue law a serious question might arise as to what portion of earned surplus would be accumulated which might be subject to a 5% additional tax.

Discuss the Answers given above. What do you consider the correct answer to the question? Give reasons.²

PROBLEM 67

CHARLOTTE MILLS, INCORPORATED—PART XII

Verification of Reserves, Profit and Loss Direct, and of Surplus Account

The following reserve accounts appear in the general and private ledgers, and in the trial balances prepared therefrom; the accounts as taken from the trial balances are as follows:

P.L. - Reserve for Depreciation	\$ 300,000.00
P.L. - Reserve for Cotton Inventories	52,120.60
G.L. - Reserve for Depreciation	2,308,234.91
G.L. - Reserve for State and Local Taxes	6,813.09
G.L. - Reserve for Federal Taxes	
G.L. - Reserve for Bad Debts	30,000.00
G.L. - Reserve for Cotton Claims	10,000.00
G.L. - Reserve for Outstanding Checks	721.30
G.L. - Reserve for Depreciation of Securities	27,500.00

Several of these accounts were verified when the assets to which they were the offsets were audited. The Reserve for Depreciation of Securities was analyzed and adjusted in conjunction

² See also Robbins, *No-Par Stock*, pp. 166-168; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 645-647; Finney, "Dividend Paid in No-Par-Value Stock," *Journal of Accountancy*, Vol. XXXVII (June, 1924), pp. 388-390.

with the verification of securities (Part II of the Problem, pp. 83-88); the Reserves for Depreciation were verified in conjunction with the plant accounts (Part VII, pp. 236-237); the Reserves for Bad Debts and for Cotton Claims were analyzed when the Accounts Receivable were verified (Part IV, pp. 141-145); and the Reserve for Outstanding Checks was included in, and scheduled with, the current liabilities (Part IX, p. 279). The Reserve for Cotton Inventories was given partial consideration when the inventories were verified (Part V, pp. 152-164).

Reserve for State and Local Taxes

The tax year for state and local taxes in Massachusetts is from April 1 to March 31. Tax bills for real estate taxes are rendered in September and are due October 1; if not paid by October 15 a penalty is added. The total real estate taxes paid in 1923 amounted to \$27,252.36; since the tax rates and the company's property had remained practically unchanged, the comptroller had accrued, at June 30, 1924, one-fourth of this amount; the charge had been made to Miscellaneous Taxes. Various other taxes amounting to \$1,837.13 had also been paid during the past year and charged to the Miscellaneous Taxes account; no accrual had been made on account of these. The payments for 1923 taxes were verified by examining the receipted tax bills, and tracing the payments into the cash book.

Reserve for Federal Taxes

When the June 30, 1923, accounts were audited it was estimated that approximately \$100,000 was necessary to provide for federal income taxes for the fiscal year ending that date; accordingly, a reserve for that amount was set up in the books and shown in the balance sheet. The actual computation of taxes, for the filing of the income tax return, however, showed the actual amount to be \$96,495.96; payments were made in quarterly instalments and charged to this account. When the first instalment was paid September 15, 1923, an entry was also made charging this account for \$3,504.04 and crediting Surplus, this being the difference between the reserve set up and the actual taxes to be paid. The quarterly payments were traced to the cash book and the canceled checks examined.

The agents of the Internal Revenue Department have audited the company's books to June 30, 1921, and no additional assessments were found necessary, except a small amount applicable to 1918 which had been paid (see surplus analysis). All income tax returns since that date have been prepared by you; you are satisfied that no additional assessment of importance will be made by the Internal Revenue Department; no additional provision on this account is therefore considered necessary.¹

Reserve for Cotton Inventories (P. L. 14)

In conjunction with the audit as of June 30, 1923, this reserve for \$296,524 was set up to reduce the raw cotton inventory to market prices. During the year debits totaling \$244,403.40 were made to the account; these debits were monthly summary entries, and applied to the bales of cotton on hand at June 30, 1923 which were put into process during the respective months. The balance of \$52,120.60 at June 30, 1924 represents the balance of this reserve applicable to the cotton on hand at June 30, 1923, and which was still on hand, and was included in the inventory of June 30, 1924 at original cost prices.

A test was made of this account, and for this purpose one month's charges to the account were analyzed in detail. The debit of \$29,526.87 made September 30, 1923 was selected; the report showing the bales of cotton put into process during September was checked and the bale markings in the report were compared with those in the inventory records of June 30, 1923. The amount of reserve per pound multiplied by the pounds of cotton in the bales used was found to make \$29,526.87. This procedure really means that the cotton on hand at June 30, 1923 was charged to production during the following year at market prices prevailing at June 30, 1923. At June 30, 1924, the reserve was again adjusted to measure the excess of the cost price of inventories on hand over the market values (see Part V).

Profit and Loss Direct (P. L. 41)

This account had been credited during the year with the following amounts:

¹ The auditor should, however, compute the approximate tax for the fiscal period under audit, and take up the amount as a liability as at June 30, 1924.

November 1, 1923 - Dividend of \$3 per share on 1,000 shares of the stock of the Boston Cloth Mills	\$3,000.00
April 1, 1924 - Regular dividend of \$5 per share on 636 shares of the Amos Manufacturing Co.	3,180.00
April 1, 1924 - Extra dividend of 50 cents per share on 636 shares of the Amos Manufacturing Co.	318.00
May 1, 1924 - Dividend of \$3 per share on 1,000 shares of the Boston Cloth Mills	3,000.00
June 30, 1924 - Adjustment of the Accounts Payable Control account to agree with the total of the unpaid items in the Voucher Register	2.00
Total credits	<u>\$9,500.00</u>

The above dividends were verified by reference to *The Commercial and Financial Chronicle*; the receipts were traced to the cash receipts book.

Surplus (P. L. 35)

An analysis of the Surplus account showed that entries had been made to it during the year as follows:

Debits

10/ 1/23	Dividend on 15,000 shares of 2nd preferred stock, at 3½%	\$ 52,500.00
12/31/23	Dividend on 10,000 shares of 1st preferred stock, at 3%	30,000.00
4/ 1/24	Dividend on 30,000 shares of 2nd preferred stock, at 3½%	105,000.00
6/15/24	An additional assessment for Federal Income Taxes for the taxable year ending June 30, 1918	1,391.89
6/30/24	Dividend on 10,000 shares of 1st preferred stock, at 3%	30,000.00

Credits

6/30/23	Balance ²	\$1,176,134.86
9/15/23	Reduction of the Reserve for Federal Taxes to actual tax liability	3,504.04
12/31/23	Profit on \$125,000 of the company's bonds purchased at 96	5,000.00
1/ 2/24	Dividend received on stock of the Cotton Products Co.	15,000.00
	Dividend received on stock of the Textile Selling Corp.	10,000.00
6/30/24	Balance (carried down)	990,747.01

Dividend declarations were verified by reference to the minutes of the board of directors. The additional assessment for 1918 taxes was verified by examining the special notice of the Collector of Internal Revenue, and from a perusal of field agent's report (a copy of which the company had) you satisfied yourself that the department intended making no further assessment; the payment of the special assessment was traced to the cash dis-

² The balance of Surplus account at June 30, 1922 was \$526,842.43. The net profit for the year ended June 30, 1923 was \$814,292.43; dividends declared during the year amounted to \$165,000, and the balance at the close of the year, as shown by this item, was \$1,176,134.86.

bursements book. Dividends received from the selling companies were traced to the cash receipts book; dividends declared by these companies were verified by reference to *The Commercial and Financial Chronicle*.

Examine critically the verification procedures outlined above, and record the findings in usable form in your working papers. Should any additional information have been obtained? If so, what? Was too much verification work done in any respect?³

PROBLEM 68

W. & J. BURROUGHS, INC.

Audit of Surplus Account

You have been employed by Wm. Burroughs, president of W. & J. Burroughs, Inc., to audit the accounts of the company for the year ended April 30, 1928, and to certify the balance sheet of the company as of that date. Aside from minor corrections in the accounts, concerning which there was no difference of opinion on the part of the company and yourself, the verification showed the accounts to be correctly stated except in so far as the following situation might affect them.

Your analysis of the Surplus account for the period under review revealed a debit item in that account of \$50,000, representing losses of merchandise on consignment, and current account in the case of the failure of a large customer. There was also a credit item in the account exactly offsetting the above loss, and representing the donation to the company of 500 shares of capital stock of a par value of \$100 each. The balance in Surplus at the beginning of the period under audit was \$20,000; the net profit for the period was \$12,000, aside from the two amounts stated above to have been debited and credited, respectively, to the Surplus account.

The 500 shares of capital stock donated during the year was still in the treasury at the date of your audit, and was examined by you during the regular course of your verification. At April 30, 1927 the stock had a book value of \$110 per share; the stock

³ See Federal Reserve Board, "Verification of Financial Statements," pars. 111-115; Jackson, *Audit Working Papers*, pp. 133-152; Bell, *Auditing*, pp. 290-301; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 313-317, 328-343.

was closely held, and so had no quoted market value at April 30, 1928.

Wm. Burroughs, president of the company, has informed you that he did not wish either the \$50,000 loss on customers' account or the stock donation to appear in the balance sheet (in the details of the Surplus),¹ nor in the income statement; neither did he wish you to comment on it in your certificate.

What position would you take, and how far would you be willing to go to meet the desires of your client?

PROBLEM 69

THE EMPIRE TRADERS, INC.

Content of Profit and Loss-Surplus Account

The books and accounts of The Empire Traders, Inc., are audited annually by a firm of certified public accountants; for the fiscal year ended December 31, 1928 the results of the year's operations and the Surplus account are shown as follows in the certified accounts:

PROFIT AND LOSS-SURPLUS ACCOUNT for the Year Ended December 31, 1928

SURPLUS:

Balance, January 1, 1928	\$805,802.14	
Less: Charges not applicable to operations, including Federal Taxes	495,223.27	\$310,578.87

DIVIDENDS:

On Preferred Capital Stock	99,288.00	
		<u>\$211,290.87</u>

OPERATIONS:

Net Profit on Sales for year, after deducting Depreciation on Property and Plant	\$442,278.74	
Other Income, less Other Charges	12,079.58	454,358.32
Balance of Surplus, December 31, 1928, per Balance Sheet		<u>\$665,649.19</u>

When the company presented its certified statements to its bank, the banker expressed himself very unfavorably with ref-

¹ It is of course obvious that the treasury stock on hand at the date of the audit must be reflected in the balance sheet either as an asset or as a deduction from the issued capital stock—the president did not object to this, but he did not wish anything shown or said which would give the details of how it happened to be in the treasury. See Dickinson, *Accounting Practice and Procedure*, pp. 117, 130-133.

erence to the above statement, saying that it was "a very muddy exhibit, apparently made that way purposely to create the impression that the company showed a profit for the year, whereas in reality its surplus is off \$140,000." Upon further questioning, the banker ascertained that the above amount of \$495,223.27 deducted from the opening surplus represented a provision of approximately \$55,000 for federal taxes, and a write-down of inventories at December 31 of \$440,000.

A few days later the banker had a conference with the accountant who certified the above statement; after detailed discussion of the accounts the banker asked the accountant, "Is it ethical to draw up and certify an account in this fashion?"

What would you say? Give reasons for your answer.

PROBLEM 70

THE SHAMROCK LUMBER COMPANY

Verification of Profit and Loss Accounts

The Shamrock Lumber Company, jobber and retailer of lumber, shingles, celotex, and similar products, was located in the shipping district of San Francisco. The location which it occupied was leased on a month-to-month basis from the State Harbor Commission, and all improvements on the property—office, lumber sheds, asphalt driveways, etc.—were constructed by the company itself. Ocean-going steamers docked at the company's yards, and the Southern Pacific Lines served its yards also.

The company's fiscal year coincided with the calendar year; the annual meeting of the stockholders was held on the Monday nearest February 10. For a number of years the accounts of the company had been audited annually, and the federal income tax returns prepared by Messrs. Smith & Hamilton, Certified Public Accountants, Russ Building, San Francisco; the audit was begun early in January in order that it might be completed and the report thereon submitted in time for the annual stockholders' meeting. The federal income tax returns were usually prepared and submitted at a date somewhat later than the report.

Because of the nature of the organization, and the absence to a large extent of any system of internal check, it had been customary for the auditors to make a much more detailed check of the books and records than was customary in a regular balance sheet audit. The extent of the work had been discussed carefully with the general manager of the company; the significance of each procedure had been explained to him, and he had approved all the work to be done. To a very large extent the work done on the audit comprised a verification of all profit and loss items of the period, as well as of the assets and liabilities; the program of audit for the detailed verification, and excluding the customary verification of the balance sheet items at the close of the year, was as follows:

CASH BOOK

(a) Vouch all disbursements charged to capital or to profit and loss accounts.

(b) See that all vouchers are properly approved by the general manager, or by one of the vice-presidents.

(c) As all invoices for lumber purchases are included among the cash vouchers, check the invoices (footage and amount) to the general journal.

(d) Foot all debit and credit columns, excluding the bank deposit and withdrawal columns.

(e) Check all postings to general ledger accounts.

(f) Test thoroughly the freight charges on sales to see that they have been charged to customers.

(g) See signed receipts for all disbursements of cash other than that paid by check.

(h) Check all office salaries and payrolls to the cash book, and ascertain that all increases therein have been approved by the general manager.

(i) Analyze the expense columns for tax and report purposes.

In addition to the above the auditors followed the practice of examining all checks returned by the banks for December and for two other months of the year chosen at random; the checks were compared with the cash book for amount, and were examined for signatures, indorsements, date of payment, clearing-house stamp, etc. The receipts for the same months were traced into the banks, it

being carefully noted that each day's receipts as entered in the cash book corresponded with the deposit for that day; the customary bank reconciliation was prepared, and the petty cash funds verified, as of the close of the fiscal period.

GENERAL JOURNAL

(a) Vouch and scrutinize all journal entries, being careful to see that all journal vouchers have been approved by an official of the company.

(b) Vouch all purchases of lumber or other materials, both for footage and amount—see item (c) under "Cash Book."

(c) Check the postings for all general ledger items.

SALES

(a) Check all duplicate sales slips to see that all numbers are accounted for (all sales slips were consecutively numbered).

(b) List all sales slips on adding-machine tapes in order to verify the total credit to Sales account in the general ledger.

PURCHASES (INVENTORY ACCOUNT)

(a) Verify the inventory on hand by adding the purchases of the year (feet and amount) to the beginning inventory, and deducting the cost of sales (feet and amount); determine that the cost per thousand feet of purchases and beginning inventory has been the basis for crediting the Purchases account with the footage sold. Any discrepancies should be adjusted to agree with the physical inventory as of the close of the year.

Messrs. Smith & Hamilton followed the practice of sending two or three assistants during the slack season of the late summer or early fall to do the detailed checking called for in the above program of audit for the first six to nine months of the fiscal year; for the year 1927, the assistants during September brought the detailed work up to August 31, 1927. When the audit of the company's accounts was taken up early in January, 1928, therefore, the detailed work remained to be done for the final four months of the year only. The detailed work was usually done during January by two juniors, while the senior in charge of the assignment proceeded with the asset and liability verification; experience had shown that the work could be completed most

expeditiously in this manner. It required two able juniors from four to six days to do the detailed work called for by the program of audit for the final four months of the year; this ordinarily did not include an analysis of the expense accounts which usually required two or three days additional time. The audit for the fiscal year 1927 was begun on January 16, 1928, and was completed on January 25; the stockholders' annual meeting was scheduled for February 13.

The profit and loss section of the trial balance at December 31, 1927 was as follows:

<u>Account</u>	<u>Debit</u>	<u>Credit</u>
Sales		\$1,297,832.16
Purchases	\$1,046,093.24	
Freight - Outbound	9,551.86	
Discount	4,020.92	
Yard Expense	190,757.50	
Portland Office Expense	7,168.80	
Motor Expense		14,224.56
Mill Account		10,913.24
Rent	27,900.00	
Interest		17,531.76
Insurance - Mill	1,936.64	
Insurance - Motors	533.68	
Insurance - Yard and Office	6,450.32	
Property Taxes	7,798.38	
Automobile Expense	1,329.58	
Depreciation	4,940.00	
Bad Debts	742.08	
Stationery and Office Supplies	2,428.06	
Dividends Received		373.32
Totals ¹	<u>\$1,311,651.06</u>	<u>\$1,340,875.04</u>

Every expenditure made on any of the above accounts was covered by an invoice or voucher, and, in accordance with the instructions set forth in the audit program, all of these invoices or vouchers were inspected by the auditors. Except for a few small items charged to Mill account that should have been debited to Yard Expense, no errors were found; these errors were so inconsequential that the general manager suggested that no adjustments be made for any of them. Similarly, the duplicate sales slips were all examined, and all numbers were accounted

¹ The difference between these two totals, \$29,223.98, subject to any adjustments which will be made as a result of the audit, including adjustment of the inventory, obviously must represent the net profit for the year ending December 31, 1927.

for; the totals of the monthly slips were in agreement with the postings made to the Sales account in the general ledger. A record of the sales footage was recapitulated in the stock books; the footage shown by the duplicate sales slips was computed, and was found to agree by months with the stock books. Previous audits had shown the books to be well and accurately kept, and the audit for the fiscal year 1927 had proved to be no exception in this respect.

Having completed the examination of the vouchers and duplicate sales slips, and the additional clerical work required in the detailed verification of the transactions of the year, the junior assistants were assigned the task of analyzing the profit and loss accounts for tax and report purposes. Where it was easiest to make the analysis by months, as in the case of sales, purchases, yard expense, and similar accounts, it was done in that way; in other cases, the nature of the transactions making up the debits and credits to the various accounts was ascertained, and a record made accordingly.

In the case of sales, the analysis was made by months, showing for each month the footage sold for redwood lumber, pine lumber, shingles, lath, celotex, and miscellaneous, the total sales of all products for the year amounting to 39,651,440 feet. The Sales account had total credits for the year of \$1,308,980.70, which amount represented the gross sales of the period; there were debits in the account of \$11,148.54, this amount representing the sales returns and allowances. Credit memoranda were examined for all returns and allowances; in the case of returns the assistants ascertained that the footage had been added back in the stock books. The net balance in the sales account, \$1,297,832.16, was included in the trial balance under the caption of Sales.

An analysis of the Purchases account revealed that the account was in reality a Cost of Sales account; the inventory account was adjusted each month to agree with the stock books, the difference being debited or credited to Purchases account. Similarly, various other expenses which affected the cost of lumber were debited to this account; the analysis of the account resulted in the following:

<u>Item</u>	<u>Debits</u>	<u>Credits</u>
Purchases of lumber, etc.	\$694,870.86	
Freight - inward	148,301.32	
Stevedoring	63,517.68	
Labor-piling and trim	24,554.80	
Mill expense	73,991.84	
Motor expense	48,685.52	
Horse hire	4,158.00	
Tolls	2,805.72	
Insurance	659.04	
Miscellaneous	52.80	
Increases (net) in inventory, debited to that account and credited to Purchases		\$15,504.34

This analysis showed total debits of \$1,061,597.58, and credits of \$15,504.34; the debit balance of the account, as shown in the trial balance, was \$1,046,093.24. Vouchers, freight bills, and payrolls had been examined for the year's expenditures.

The inventory as of December 31, 1926 had recorded the lumber and miscellaneous materials on hand at 11,418,398 feet. According to the invoices and other records examined the purchases during 1927 amounted to 40,979,606 feet, making a total of 52,398,004 feet to be accounted for. The sales of the year, as already stated, aggregated 39,651,440 feet; it would appear, therefore, that there remained on hand 12,746,564 feet of lumber and miscellaneous materials as the inventory at December 31, 1927. Actually, however, the stock books showed there to be on hand as of the close of 1927, nearly 26,000 feet more than this amount, or a total of 12,772,258 feet; the physical inventory, which had been carefully taken under the direct supervision of the officials of the company, showed the amount on hand to be 12,803,208 feet, or 30,950 feet more than reflected by the stock books.

This difference of more than 56,000 feet was explained largely by the fact that much of the lumber purchased contained a larger footage than shown by the invoices, or than recorded in the stock books.² It was decided to record the inventory as of December 31, 1927 at 12,803,208 feet, and to increase the value thereof by \$3,562.34, this being the invoice value of the additional 30,950 feet shown by the physical inventory. The total value of the inventory at December 31, 1926 was \$275,719.40.

² As a specific example of the way these overruns came about, oftentimes when the company purchased 2 inches by 8 inches by 16 feet pieces the boards would run 9 inches in width instead of 8, or would be $2\frac{1}{2}$ inches thick instead of 2 inches. It was the custom of the company to record these in the stock books at what they were supposed to be; however, in selling them the purchaser would be charged for the actual width or thickness, and hence the discrepancy gradually arose.

The inventory as shown by the company's books at December 31, 1927 was \$291,223.74; the difference between these two inventory figures was the amount which had been credited to Purchases account. By the adjustment of the books to agree with the physical inventory, the amount at December 31, 1927 became \$294,786.08, which amount was shown in the balance sheet and reflected in the statement of profit and loss. The senior assistant in charge of the audit prepared an adjusting journal entry debiting Inventory and crediting Purchases for the \$3,562.34 already referred to. It was the practice of the company to value the inventory each year at cost or market value, whichever was lower at December 31.

The analysis of the Discount account showed discounts allowed to customers of \$18,432.56, and discounts taken in the amount of \$14,411.64. The Portland office expense included \$4,800 for salaries; \$720 for rent; \$344.80 for telephone and telegraph; \$506.04 for automobile expense; \$392.01 for traveling and entertainment; \$42.32 for taxes; and stationery, postage and miscellaneous of \$363.63. The Rent account represented the monthly rent of \$2,325 paid to the State Harbor Commission; the agreement for the payment of the rent was examined, and all payments vouched. Vouchers were seen, or reports examined, for all Portland office expense, and the policy of the company with reference to all discounts allowed or taken was ascertained.

The Yard Expense account was carefully analyzed, and vouchers or payrolls were examined for all expenditures. The account was found to contain the following:

Officers' salaries	\$ 56,400.00
Other salaries	56,290.00
Yard labor	63,860.88
Repairs and supplies	5,085.78
Telephone and telegraph	1,819.78
Light and power	47.74
Water	114.00
Advertising	178.60
Legal expense	1,068.50
Auditing	1,000.00
Traveling expense	270.00
Broker's commission on purchase of securities	110.00
Dues, Industrial Assoc.	960.00
Other dues and subscriptions	2,573.00
Miscellaneous	979.22
Total	<u>\$190,757.50</u>

In the case of Motor Expense and Mill Expense, the analysis of Purchases account had revealed large debits for these, whereas the trial balance showed credit balances on each of these accounts. The practice of the company was to debit these respective accounts for the actual expenses incurred, and to credit them and charge Purchases account at an arbitrary rate for all hauling or mill work done. As a consequence, the accounts had shown credit balances at the close of the year; this meant, obviously, that the expenses of the period had been over-absorbed. In the preparation of the statement of profit and loss for the year, the actual expenses would be used, that is, the debits in the Purchases account less the credit balances in the Motor Expense and Mill accounts.

Vouchers or payrolls had been examined for all these expenditures, and the analysis of the accounts showed the following:

<u>Description</u>	<u>Motor Expense</u>	<u>Mill Expense</u>
Mill work done by others on lumber purchased		\$ 4,900.58
Labor	\$25,074.52	35,581.20
Salaries		12,900.00
Supplies and repairs	2,757.98	5,565.66
Gasoline and oil	3,927.84	
Tires	1,723.30	
Licenses	862.00	
Water, light, and power		1,247.98
Horse hire		1,208.00
Miscellaneous	115.32	1,675.18
Totals	<u>\$34,460.96</u>	<u>\$63,078.60</u>

The interest income represented interest received on bank balances of \$700.86; interest on notes and accounts receivable of \$1,636.20; interest on bonds owned \$3,600; and interest on funds advanced to a subsidiary company \$11,594.70. The securities and notes receivable were examined during the course of the audit, and all changes in the accounts during the year were noted; the interest was computed and agreed with the company's figures. The amounts were traced into the cash book.

The dividends received represented two monthly dividends on the cumulative preferred stock of the Merchants Lumber Company; the dividends were on 320 shares of 7% stock, no dividends being paid after February, 1927. The dividends were traced into the cash book.

The insurance expense for the year was computed by adding to the unexpired premiums as of December 31, 1926 the payments made during 1927, and from the sum of these deducting the amount of the unexpired premiums at December 31, 1927. Vouchers were examined for all additional premiums paid during the year; the policies were seen and the unexpired premiums computed as of the close of the year. The auditor's computations agreed within a few cents with those made by the company; the company's figures were accordingly accepted without change.

Tax receipts were seen for all taxes paid during the year; the taxes consisted of the following:

California corporation license tax	\$ 75.00
California corporation franchise taxes	477.00
City and County of San Francisco	7,246.38
Total	<u>\$7,798.38</u>

Automobile expense was for gasoline, oil, etc., for the cars of salesmen. Vouchers were examined for these expenses, and for all purchases of stationery and office supplies. Depreciation was computed at fixed rates applied to the cost of the capital assets; the amounts were determined by the auditor, and the entry furnished to the company to place the amount on the books. The journal voucher, properly approved by the general manager of the company, was examined for the accounts written off as uncollectible.

Upon the completion of the verification work, and the analysis of the expense and revenue accounts as above set forth, the senior assistant in charge of the audit prepared the statement of profit and loss shown on page 340.

Criticize constructively the verification and analysis of the profit and loss accounts of The Shamrock Lumber Company. Was the verification insufficient in any respect? If so, what? What additional work should have been done? Was too much work done in any phase of the audit? If so, what? Discuss.³

Check the amounts and captions in the statement of profit and loss against the data given; do you approve the income statement as presented? If not, how would you change it?

³ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., Chs. XVI-XVIII.

The Shamrock Lumber CompanyStatement of Profit and Loss for the Year
ended December 31, 1927

Sales, less returns and allowances . . . \$1,297,832.16

Deduct:

Freight allowed to customers . . .	\$ 9,551.86		
Discount allowed to customers . . .	<u>16,432.56</u>	27,984.42	\$1,269,847.74

Cost of Sales:

Inventory, December 31, 1926 -			
11,418,398 feet	\$	275,719.40	

Lumber purchased -

40,979,606 feet	\$694,870.86		
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Less: Discounts taken	<u>14,411.64</u>		
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	<u>\$680,459.22</u>		
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Freight inward	148,301.32		
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Stevedoring	63,517.68		
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Labor - piling and trim	24,554.80		
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Mill expenses	63,078.60		
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Tolls	<u>2,805.72</u>		
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		<u>982,717.34</u>	
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		<u>\$1,258,436.74</u>	
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Inventory, December 31, 1927 -

12,803,208 feet		<u>294,786.08</u>	
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			<u>963,650.66</u>
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Gross Profit			\$ 306,197.08
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General and Selling Expenses:

Compensation of officers	\$	56,400.00	
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Office and salesmen's salaries		56,280.00	
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Yard labor		63,860.88	
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Motor and automobile expense		35,790.54	
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Rent		27,900.00	
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Portland office expense		7,168.80	
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Insurance		9,579.68	
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Taxes		7,798.38	
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Depreciation		4,940.00	
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Bad debts		742.08	
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Miscellaneous		<u>20,845.48</u>	<u>291,315.84</u>
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Profit from Operations			\$ 14,881.24
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Add: Interest earned	\$	17,531.76	
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Dividends received		<u>373.32</u>	<u>17,905.08</u>
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Net Profit, before providing for

Federal income taxes			<u>\$ 32,786.32</u>
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PROBLEM 71

CHARLOTTE MILLS, INCORPORATED—PART XIII

Analysis and Verification of Various Manufacturing,
Trading, and Profit and Loss Accounts

Before completing your audit, you desired to analyze and verify as many of the manufacturing, trading, and profit and loss accounts of the company under audit as time would permit; it was true that you were employed to perform a balance sheet audit, but it had been your practice to make the audit as comprehensive and as complete as possible.¹ In certain respects you were not so much interested in verifying the particular amounts recorded in various operating accounts as you were to test further the system of accounting in use, and to satisfy yourself that the system of internal check affords substantial protection to the company against risk of defalcations, and against the probability of expenditures being improperly classified in the accounts.

Accordingly, while you proceed to prepare the balance sheet to which you will certify and which you will include in your detailed report to the client, and while this and certain other matters are being discussed with the treasurer and other executives of the corporation, you assign your assistants to the task of analyzing, testing, and verifying certain of these accounts, as follows:²

¹ As defined in the bulletin of the Federal Reserve Board, "Approved Methods for the Preparation of Balance Sheet Statements," the scope of a balance sheet audit "for a fiscal year or other operating period of an industrial or mercantile corporation or firm comprises a verification of the assets and liabilities, a general examination of the profit and loss account, and, incidental thereto, an examination of the essential features of the accounting." In this respect it is interesting to note that Colonel Robert H. Montgomery, in his *Auditing Theory and Practice*, 4th rev. ed., makes bold to say that, "What we need is more comprehensive auditing"; with this the author is in entire agreement—the auditor must do more than the "irreducible necessities" if he is to be a constructive force in the business life of his clients and of the nation at large.

² The student should again observe that during the course of his audit of Charlotte Mills, Incorporated, he has already had occasion to verify, or analyze, a substantial number of the profit and loss accounts of the company. Thus, in connection with the examination of notes and securities (Part II of the Problem, pp. 85-87) the Interest on Mortgages, and Interest on Notes Receivable accounts were analyzed and verified, and special consideration was given to any loss which might result from depreciation of the securities or inability to collect on the notes. The brokerage and expense resulting from the purchase of additional capital stock of the Amos Manufacturing Co. was also analyzed and verified.

During the verification of the general cash funds you took up in the accounts any interest on bank balances not already recorded in the books; you also satisfied yourself, by an analysis of the Interest on Bank Balances account, that all interest earned during the year on bank balances had been taken up in the books. The sufficiency of the Reserve

Sales and Returns

The sales records for the various mills were scrutinized for the months of February and June, 1924. For the month of June all duplicate sales slips for mill products sold by the Cotton Products Company were examined and agreed with the sales books; these were found to be in agreement. In conjunction with the verification of accounts receivable it had been ascertained that sales records had been closed on June 30; in the case of returned sales, tests were made of the receiving records to ascertain that the goods were actually received back into stock. Sales contracts were examined, and the future bookings of the company inquired into (see Part V of the Problem, page 160). Time did not permit of further examination with reference to these accounts.

Other Income—Rentals

The balances in these accounts were shown net in the trial balance; inquiry was made concerning the handling of the accounts, leases were inspected, occupancy records were scrutinized, the larger items of maintenance and expense were vouched, and your assistant was satisfied generally that the accounts reflected what they purported to show.

for Bad Debts was considered in Part IV of the Problem, pp. 141-145; all losses on account of uncollectible receivables were provided for at that time.

The inventory verification presupposed an examination and knowledge of the methods of taking the inventory, and of the cost-finding methods in use in the Charlotte Mills organization. Losses arising from waste, spoilage and obsolescence of goods, drop in market price of inventories on hand or contracted for, etc., were considered and provided for. Purchasing, storing, and requisitioning methods were considered to be satisfactory.

In the verification of capital additions special attention had previously been given to the company's method of accounting for capital and revenue expenditures, and you satisfied yourself that these expenditures were properly entered in the accounts. The question of depreciation was gone into thoroughly, and any adjustment which you believed necessary was made in the provision for the year under audit. All losses arising from the dismantlement of plant items were scheduled so that they might be included in the expenses of the current year. It was noted that moving and similar expenses had been debited to the proper revenue accounts.

In the verification of the insurance prepaid, the total charges of the year were verified, and the insurance expense of the period determined. The discount on bank loans and banker's notes was analyzed at the time the notes payable were verified; the interest expense of the year was thus determined. Bond interest and the amortization of bond discount were computed and adjusted in connection with the verification of funded debt; the interest on stock subscriptions was verified in conjunction with the verification of capital stock.

Verification has been made of the expense of the year on account of state and local taxes; likewise all payments because of federal income taxes were traced into the books, and the canceled checks examined. All expenses discovered during the course of the audit which had not already been entered in the accounts were properly recorded, and charged against the profits of the year; a certificate had been obtained from responsible officials of the company to the effect that all known expenses were included in the books of account.

Dividends received on securities owned were traced into the cash book, and verified by reference to proper sources; dividends paid were traced into the cash disbursements book and were found to have been properly authorized in the minutes.

From the above it will be observed that many of the income and expense items have been verified in conjunction with the verification of the balance sheet items; in addition the auditor will undoubtedly desire to test various other income and expense accounts, somewhat as outlined above. See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 791-792.

Manufacturing Expense

The manufacturing expenses, as shown by the company's analysis sheets, were carefully scrutinized; the balances shown in the trial balance were found to include not only direct labor but also all normal direct overhead charges (except depreciation and taxes, which were shown as separate items in the trial balance). The payrolls for the second week in April, 1924, were verified in detail; this involved an examination of the employment department records, the time-clock cards, the payrolls and the clerical computations thereon, the payroll receipts, and so forth. Because of the detail involved in the verification of the payroll, this work had been done during the latter part of May as interim work on the audit. In conjunction with the work of previous years the auditors had satisfied themselves that the general safeguards surrounding the preparation of the payrolls, and the paying off of the employees, were satisfactory; accordingly only a single payroll chosen at random from the year's operations was verified. This payroll was found to be correct.

Some of the larger items of expense on account of supplies, power, and so forth, were vouched; all items examined were found to be properly supported by invoices or requisitions, and in accordance with the books of account. For the purposes of the limited-test audit this general scrutiny of the accounts was considered by the assistant in charge of this work to be sufficient, and no further verification was made.

Operating Office Expenses

As in the case of the manufacturing expenses a general scrutiny was made of the operating office expenses. In accordance with previous audits, and as per your understanding with the client, only a very limited test was ever made of the various amounts recorded under the several expense classifications. Thus, the salaries accounts were verified for the month of November, 1923, and the larger items of expense for that month were vouched. The Dues and Publications account and the Expense-Welfare and Gratuities account were analyzed for income tax purposes; the latter account was found to contain contributions in the amount of \$1,500 which would not be deductible for income tax purposes.³

³ See Regulations 62, Article 562; also, Regulations 74, Article 262.

Boston Office and General Administrative Expenses

A general scrutiny and verification of the Boston office and general administrative expenses were made, similar to that for the operating office expenses. Salaries were verified from the salary books, and the larger items of expense were analyzed and vouched. An additional amount of \$1,000 of contributions was found among the Boston office expenses, and, for purposes of the federal income tax return, was segregated with the contributions found in the operating office expenses.

Strike and Shut-Down Expense

These accounts were analyzed, and were found to represent the expense of carrying the Melrose mill during certain labor troubles that had arisen during the year under review.

The remaining profit and loss accounts, except in so far as they had been analyzed and verified in conjunction with certain items on the balance sheet, were not verified. It was felt that "a general examination of the profit and loss account" had been made; accordingly, the work was brought to a close.

Criticize constructively the verification made of the operating and profit and loss accounts of Charlotte Mills, Incorporated for the fiscal period ended June 30, 1924. For purposes of a balance sheet audit, should additional work have been done in any respect? If so, what? Was too much verification made of any of the accounts? If so, what? Discuss in detail.⁴

⁴ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 344-385; also pp. 547-625.

Part VII—The Final Statements, Certificates, and Reports

PROBLEM 72

MONGOL OIL REFINING COMPANY

Preparation of Balance Sheet after Audit

You have completed your audit, and are now ready to prepare for certification the balance sheet of the Mongol Oil Refining Company, a New Jersey corporation located at Bayonne, New Jersey. The company operates a large oil refinery, purchases crude oil from the Mexican and California fields, and sells gasoline and other oil products throughout New Jersey, New York, and Pennsylvania. It owns, through a subsidiary company, the Mongol Oil Steamship Company, its own fleet of tankers by means of which it transports the crude oil from the fields to the refinery. The company's fiscal year ends at December 31.

The company went into receivership during the latter part of 1927, and was reorganized as of March 1, 1928. Under the plan of reorganization the first mortgage bonds of the company remained in full force and effect, but otherwise the capital structure was completely changed; \$2,500,000 of 7% General Mortgage Sinking Fund Gold Bonds were issued, dated January 1, 1928 and maturing January 1, 1943; \$5,000,000 of preferred capital stock with a par value of \$100 a share was authorized, of which \$3,700,000 was issued. The excess equity in the company's assets, after certain assets had been revalued and the accounts adjusted to the new values, was represented by no-par common stock, of which 1,500,000 shares had been authorized.

In order that the general mortgage bonds might be sold more effectively, it was arranged (a) that certain trustees, known as voting trustees, should take over 500,000 shares of the no-par common stock, (b) that each purchaser of a \$1,000 general mort-

gage bond would have the option of buying on or before January 1, 1938, 200 shares of the no-par common stock of the company at \$5 per share, and (c) that the 500,000 shares of stock in the hands of the voting trustees would be used to issue stock to those who took advantage of this privilege under the general mortgage indenture of trust. Such stock not so issued by January 1, 1938, would be returned to the company's treasury, for disposition by the stockholders and directors.

Of the remaining common stock 831,848 shares had been issued; 549 of these shares had been reacquired and were held in the treasury. By vote of the board of directors, 140,152 of the remaining unissued shares were reserved for issue to officers and employees of the company over a period of three years. These shares would be issued in January 1929, 1930, and 1931 as additional compensation for services rendered in the respective preceding years; practically all of this stock constituted a bonus to the group of bankers and attorneys who controlled the company.

Three thousand shares of the 7% preferred stock had also been reacquired by the company and were held in the treasury. The preferred stock was cumulative as to dividends; dividends were payable quarterly, beginning June 1, 1928, but no dividends had been paid during the year under audit.

Besides the Mongol Oil Refining Company, there were a number of wholly owned subsidiaries. The Mongol Oil Steamship Company held title to the organization's fleet of seven steel tankers; this company's sole asset was the fleet, valued on its books at \$3,500,000, and its sole liability was \$2,990,000 of 7% purchase mortgage bonds. These bonds, which were guaranteed both as to principal and interest by the Mongol Oil Refining Company, matured over a period of fifteen years from January 1, 1927 in equal monthly instalments. The net equity of the Steamship Company is represented by 6,000 shares of no-par stock, and is carried in the books of the parent company at actual cost to it; the difference between the net worth shown by the subsidiary company's books, and the cost of \$571,869 shown in the books of the parent company, represents legal and other expenses with reference to the organization of the Steamship Company and the acquisition of the steel tankers.

In the case of all the subsidiary companies only balance sheet

accounts were carried in their books of account; all trading and profit and loss transactions were recorded directly in the books of the parent company.

Another wholly owned subsidiary was the Gobi Oil Company; this company was organized subsequent to the parent company's reorganization to hold title to all real estate thereafter acquired. All real estate purchased by the Mongol Oil Refining Company subsequent to the date of the general mortgage bonds became, by the provisions of the trust indenture, subject to that mortgage; by means of the subsidiary company holding title to such real estate it would not become subject to the general mortgage. The amount of \$4,618 shown in the parent company's books is its actual investment in the Gobi Oil Company; this is represented by 500 shares of capital stock of no-par value.

The Gogol Oil Storage Company was organized to hold certain oil leases, and to acquire additional leases and the stocks of other companies which owned oil lands or were carrying on development work. The company owned oil leases in the Mexican fields, and also owned the entire capital stock of the Mongol Oil Corporation, Ltd., which in turn owned leases on undeveloped oil lands in Venezuela. From time to time the Mongol Oil Refining Company made direct advances of cash to these companies; these advances were spent in experimental work, in surveying the tracts, in drilling wells, and for other operating purposes. The actual advances made to the Mongol Oil Corporation, Ltd. amounted at December 31, 1928 to \$91,872; these charges were all capitalized on the books of the corporation. The advances to the Gogol Oil Storage Company amounted to \$48,500, and represented the investment of the parent company in the subsidiary; by resolution of the board of directors, dated March 19, 1928, the increase to the present figure was voted.

Inasmuch as the title to the crude oil and refined products was in the Colonial National Bank, the Mongol Oil Sales Company was organized to hold title to the trade accounts receivable arising from the sale to customers of gasoline, refined oil, and sundry refined products. The capital stock of this company, which was only \$1,000 (ten shares of a par value of \$100 each), was held entirely by the Colonial National Bank; thereby the bank had title to the accounts receivable arising from merchandise

sold. Included in the accounts receivable of the Mongol Oil Refining Company was an item of \$1,000 owed by the Colonial National Bank, and representing the capital stock of the Sales Company. When oil products were sold to outside customers, the Mongol Oil Refining Company billed the Mongol Oil Sales Company for the selling price of the products; the Sales Company in turn billed the customer, and when the invoice was paid it was paid by the customer to the Sales Company. By this procedure the Sales Company showed no profit in its books; all sales of products were reflected in the Refining Company's books, and profits were taken up by that company. The amount shown as owing by the Sales Company to the Refining Company therefore consisted of accounts receivable owed by customers; these accounts were of not more than sixty days' standing, for by agreement with the bank past-due accounts were assumed by the Refining Company and cash substituted therefor. The reserve for bad and doubtful accounts on the books of the Refining Company was presumed to provide for the Sales Company's uncollectibles also.

The general ledger trial balance of the Mongol Oil Refining Company, after the income and operating accounts had been closed into Profit and Loss, is given below. A balance sheet as of December 31, 1928 is to be prepared; the facts should be presented in such form that they will be most helpful to the executives of the company, but also so that they may be submitted to the stockholders at their annual meeting, to the company's bankers, and to prospective investors in the securities of the company. The trial balance, after closing, follows:

MONGOL OIL REFINING COMPANY		
Trial Balance, after Closing, December 31, 1928		
<u>Accounts</u>	<u>Debits</u>	<u>Credits</u>
Land - at cost	\$ 98,323.00	
Land - increased by appraisal, per resolution of Directors of March 19, 1928	725,964.00	
Refinery and Equipment - at cost	5,376,503.00	
Marine Equipment - at cost	213,580.00	
Equipment at Customers' Plants	17,968.00	
Patent Fees and Expense (cost)	3,613.00	
Mongol Oil Steamship Company Stock	571,869.00	
Gobi Oil Company Stock	4,618.00	
Notes and Accounts Receivable from Gobi Oil Company	17,517.00	

Accounts	Debits	Credits
Gogol Oil Storage Company Stock	\$1,270,000.00	
Advances to Mongol Oil Corporation, Ltd.	91,872.00	
Owed by Mongol Oil Sales Company	594,577.00	
Cash - in banks and on hand	73,525.00	
Miscellaneous Reserve Cash Funds	7,203.00	
Cash held in Escrow for Mexican taxes	60,691.00	
Notes Receivable	3,580.00	
Accounts Receivable	117,712.00	
Insurance Claim on Oil Lost at Sea	73,544.00	
Inventory of Crude Oil and Refined Products, title to which is in Colonial National Bank	795,830.00	
Crude Oil in Transit (title in bank also)	148,730.00	
Manufacturing Materials and Supplies	120,510.00	
Prepaid Interest, Insurance, Taxes, Advances, etc.	150,795.00	
Undistributed Charges of Tanker Fleet	89,878.00	
Common Capital Stock		\$ 1,479,561.00
7% Preferred Stock Authorized		1,300,000.00
Unissued Preferred Stock	1,300,000.00	
Preferred Stock Outstanding		3,700,000.00
Treasury Stock - 7% Preferred	300,000.00	
First Mortgage Ten-Year 6% Gold Bonds, due March 1, 1937		1,067,900.00
General Mortgage Fifteen-Year 7% Sinking Fund Gold Bonds, Series "A," due January 1, 1943		2,500,000.00
Five-year 7%-series Gold Notes (called for re- demption July 1, 1928)		500.00
Tanker Trust Notes - dated January 2, 1928, payable in quarterly instalments over 5 years		274,100.00
*First Mortgage 5% Bonds, issued by Pacific Steamship Company, Incorporated		11,250.00
*Notes Payable to Pacific Steamship Company, Incorporated, secured by second mortgages		11,760.00
*Payments due Asia Towboat Co. (*Purchase money obligations under pur- chase of Steamer "M. S. Semiramis" and Tug "Vaterland #2," secured by a mortgage payable serially over three years.)		8,487.00
Bank Loans Payable, secured by inventory of oil (contra) title to which is vested in Colonial National Bank		312,500.00
Notes Payable, due August 1, 1929 and 1930		35,000.00
Accounts Payable		223,865.00
Accrued Salaries and Wages		8,697.00
Accrued Interest on Notes Payable, Taxes, Lia- bility Insurance, etc.		15,182.00
Accrued Interest on First Mortgage 6% Gold Bonds		21,358.00
Provision for Mexican and U. S. Federal Taxes		50,541.00
Reserve for Depreciation		1,242,356.00
Reserve for Bad and Doubtful Accounts and Notes Receivable		74,641.00
Reserve for Repair of Tankers		139,877.00
Reserve for Claim of Honolulu Transport Com- pany (counterclaim of approximately same amount not shown among assets)		91,978.00

<u>Accounts</u>	<u>Debits</u>	<u>Credits</u>
Loss from Steamship "Urga" lost at sea during July, 1928	89,746.00	
Loss from Operations for the ten months ended December 31, 1928	251,405.00	
	<u>\$12,569,553.00</u>	<u>\$12,569,553.00</u>

Although the income and expense accounts had been closed out monthly to the general profit and loss account, and therefore did not appear in the ledger at the time of preparing the above trial balance, certain additional information should be considered in preparing the balance sheet called for. There was other oil, purchased on open account, which was in transit at December 31, 1928, and which was valued at \$122,264; the existence of this asset had been ascertained by determining the location of each tanker owned and operated by the company at December 31, 1928, and by computing the value of the oil aboard these tankers.

The loss from operations shown in the trial balance was for the last ten months of 1928 only. Since the reorganization took place as of March 1, 1928, the loss for the months of January and February, amounting to \$97,667, was capitalized. The total operating loss for the calendar year, therefore, was \$349,072.

In order that oil might be shipped from the Mexican fields it was necessary to guarantee the payment of the government tax which is levied on each barrel of oil taken from the wells. This was accomplished by placing cash in escrow with the Colonial National Bank to guarantee the payment of the taxes. When a tanker of oil was loaded for shipment the company was notified of that fact; the liability for the Mexican taxes was computed, and cash for the amount of the liability was transferred in escrow to the bank for payment of the taxes upon presentation of the shipping documents. The liability for such taxes was recorded in the accounts by debiting Crude Oil and crediting Provision for Mexican and U. S. Federal Taxes. When a cargo of oil was received at the refinery the shipping documents were presented to the Colonial National Bank for the payment of the taxes in order that the oil might be unloaded; the tax was remitted directly by the bank to the Mexican government.

During July, 1928, one of the steel tankers owned by the Mongol Oil Steamship Company was lost at sea. No trace, except one charred plank recovered off the coast of Spain, was ever

found of the boat or any of the crew. After all insurance had been received, the total loss on the tanker amounted to \$89,746.

The crude oil on the boat which was lost at sea was also covered by insurance, but certain difficulties had arisen in determining the amount of the insurance claim. The company's technical experts estimated the loss at \$73,544, and this amount was set up in the books as an insurance claim on oil lost at sea. The company's comptroller believed that this amount, and perhaps slightly more, would eventually be received from the insurance company; in fact, during the latter part of January, 1929, while you were still engaged on the audit of the accounts, the company received a check from the insurance company in full settlement of the claim as set up in the books of account.

The equipment at customers' plants represented pumps, etc., necessary for handling the oil purchased from the company. The refinery and equipment, and the marine equipment, were all maintained in excellent condition; all were used in the conduct of the business of the company. The provision for depreciation is believed to be ample, though not excessive. The increase in the book value of the land, and of the investment in the Gogol Oil Storage Company, took place in connection with the reorganization of the Mongol Oil Refining Company.

The inventories of crude oil and refined products were valued at cost, while those of manufacturing materials and supplies were valued at cost or market, whichever was lower at December 31, 1928. Because of the financial standing of the Refining Company, and yet to enable it to obtain current working funds, an agreement between the Mongol Oil Refining Company and the Colonial National Bank was entered into whereby the title to all oil and oil products was vested in the bank; the title to the oil passed directly from the vendor to the Colonial National Bank.

By the method of accounting in use the Refining Company distributed the costs of operating the tanker fleet to the various commodities produced. These charges, however, were not debited to the various material accounts immediately, but were charged to each cargo of oil as it was delivered to the company's refinery. Accordingly, there was always a considerable amount of undistributed charges; these represented supplies, fuel, etc., for consumption by the tankers on trips to and from the oil fields.

It was the practice of the company to make provision for repairs to the oil tankers. On the basis of experience it was estimated at the beginning of each year what amount would be necessary to keep the tankers in repair. This amount was divided by 365 in order to determine the daily provision for repairs. At the end of each month a bookkeeping entry was made debiting Oil in Process, and crediting Reserve for Repair of Tankers. When repairs actually were necessary, the cost thereof was debited to the Reserve account.

The notes payable due August 1, 1929 and 1930 represented notes given to attorneys for services rendered with reference to the reorganization of the Refining Company. One-half of the amount was payable in 1929, and half on August 1, 1930.

The amount standing as a credit to Common Capital Stock represents the excess of assets, as adjusted at the date of the reorganization (March 1, 1928), over the sum of the liabilities and the preferred stock. This amount was not changed during the period under audit when certain shares were reacquired and placed in the treasury; neither was any change made in January, 1929, when additional shares were issued as a bonus to officers and employees, as set forth above.¹

Two lawsuits were pending against the company. In the case of the Honolulu Transport Company there was a counterclaim of approximately the same amount; however, because of the improbability of collecting the claim, the company did not include it among its assets. It had, nevertheless, set up a special reserve to provide for the claim of the Honolulu Company.

A second lawsuit was pending because of an alleged breach of contract with Jefferson, Hyde & Company. This latter company had a contract with the Mongol Oil Refining Company to receive a certain quantity of fuel oil monthly, for a three-year period, at a certain stipulated price. Because of contingencies which had arisen, the oil had not been delivered as provided in the contract. The Mongol Oil Refining Company maintained that Jefferson, Hyde & Company had refused to accept the oil, whereas the other company stated that it had suffered severe losses because the agreed amount of oil had not been furnished. No amount had been estimated in case a judgment was given.

¹ See Problems 65 and 66, pp. 317-325.

In the case of all other accounts included in the foregoing trial balance, assume that the amounts are correct and that the titles to the accounts fairly represent the facts. The balance sheet should be prepared so as to set forth clearly the financial position of the company, and so as to give the maximum information to those who are financially and otherwise interested in the company's affairs.²

PROBLEM 73

TAHOE MANUFACTURING COMPANY

Current Assets in Certified Balance Sheet

The Tahoe Manufacturing Company presented to its bank a certified balance sheet as of October 31, 1928 in which "Total Current Assets" and "Total Current Liabilities" were specifically segregated. Below the current liability group in the balance sheet and immediately above the "Capital Stock" was a group of items entitled "Deferred Liabilities"; included in this grouping was an item:

Provision Out of Current Year's Earnings for Inventory Losses \$8,150,000

The banker commented on this item, stating that "it is very evident that this item is set up in this way so that the Company may make a two-for-one statement"; however, even to accomplish this it had been necessary to include among the total current assets the following items:

Due from Officers and Employees on account of Purchase of Common Capital Stock and Sundry Advances (secured by deposit of stock as collateral)	\$6,264,000
House and Lot Accounts Receivable, and unsold Real Estate of the Cascade Land & Improvement Company, less mortgages	\$3,632,000

The banker frankly told the treasurer of the Tahoe Manufacturing Company that, since the item of \$8,150,000 represented an established loss on merchandise, it should have been deducted from that item, or else included among the current liabilities—

² See Hatfield, *Accounting*, pp. 26-57.

which, of course, would not be the proper way to show it. "Altogether," he commented, "you have a wonderfully window-dressed statement."

Were the criticisms of the banker justified? If the company had preferred to state the merchandise inventory in its balance sheet "at cost," could not this have been done without setting up at all the provision of \$8,150,000? In view of the fact that the two above items included in the current assets were clearly set forth in the balance sheet, is it not possible that they were properly included among the current assets? Discuss the various angles of the above situation, and give reasons for your views.

PROBLEM 74

VIRGINIA-WASHINGTON COMPANY

Content of Current Assets

The accounts of the Virginia-Washington Company were audited as of October 31, 1928 by Messrs. East, South & Co., Richmond, Virginia. The asset side of the balance sheet was shown, as audited, in the following form:

RESOURCES		
<u>CURRENT ASSETS:</u>		
Cash	\$1,969,936.72	
Accounts Receivable	2,235,405.68	
Notes Receivable	448.46	
Miscellaneous Accounts Receivable	439,975.91	
Stocks, Liberty Bonds, etc.	1,724,390.58	
Merchandise Inventory	3,674,281.07	
Supplies Inventory	508,217.86	\$10,552,656.28
<u>FIXED ASSETS:</u>		
Land and Buildings	\$3,495,378.23	
Machinery, Equipment, etc.	1,974,622.05	
Refrigerator Cars, Auto Trucks, etc.	627,892.92	6,097,893.20
<u>DEFERRED CHARGES:</u>		
Prepaid Interest, Insurance, etc.		131,952.98
		<u>\$16,782,502.46</u>

The certified balance sheet, of which the above was a part, was submitted in due course to the company's banker; the banker

insisted that while the accountants did not specifically state that the amount of \$10,552,656.28 was "quick assets," the balance sheet was drawn up in a way very directly to carry this inference. The banker accordingly took up with the treasurer of the Virginia-Washington Company certain of the above items, as follows:

(a) *Miscellaneous Accounts Receivable*, which represented:

Due from affiliated company for plant additions	\$153,412.62
Due from same company for half-year's losses	181,161.29
Miscellaneous claims, advances, etc.	105,412.00
Together	<u>\$439,975.91</u>

(b) *Stocks, Liberty Bonds, etc.*, of which (i) Liberty Bonds represented \$30,000, (ii) the common stock of an oil refining company in southern Virginia \$999,000, (iii) the stock of a real estate company, holding property formerly carried in permanent assets, \$650,000, and (iv) miscellaneous items of doubtful value \$45,390.58.

Before 1924, a local accountant had audited the books and had always drawn up the figures in the above fashion; since that time Messrs. East, South & Co. have done the audit. The banker stated, "You can put two and two together and get the answer."

Comment on the situation as revealed above.

PROBLEM 75

THE ALPHA CORPORATION

Audit of Affiliated Companies

The Alpha Corporation, whose offices and plants are located near Baltimore, is engaged in the production of heavy iron and steel products. It owns valuable ore beds in South America, and transports the ore in steel vessels owned by a subsidiary company. You audit and certify the companies' accounts annually.

The vessels referred to above were purchased in late 1920 from the U. S. Shipping Board. For this purpose The Alpha Corporation organized The Beta Steamship Company, which in turn purchased seven steel vessels (comprising the above fleet) for \$10,000,000. Cash in the amount of \$200,000 was paid at the time of purchase, and a first mortgage on the vessels was given for \$9,800,000, bearing interest at 7% per annum, and

maturing serially, in equal amounts, over a fourteen-year period. All of the capital stock of The Beta Steamship Company was owned by The Alpha Corporation; the parent company immediately leased the ships under an agreement whereby it assumed all operating and maintenance charges for the fleet, and provided for depreciation and replacements—these were assumed to be the full rental value of the ships.

During 1921, the value of shipping decreased very rapidly—so much so that shipbuilding companies which had received in the neighborhood of \$200 per deadweight ton for ships in 1920 were bidding for work by the close of 1921 at around \$80 per deadweight ton. Correspondingly, the value of the steel vessels owned by The Beta Steamship Company dropped to one-half, or even less, of the amount at which they had been purchased; because of this The Beta Steamship Company defaulted both the interest and the \$700,000 principal due in 1921, preferring to let the Shipping Board take back the vessels. The Beta Steamship Company owned no other property.

The Shipping Board apparently did not desire, however, to take back the ships; instead, the mortgage was advertised for sale, and on the date named was sold at public auction. Meanwhile, The Alpha Corporation had organized, as a wholly owned subsidiary, The Chi Steamship Securities Company, which purchased at the public auction in New York the above \$9,800,000 mortgage for \$4,000,000 cash.

In order that The Chi Steamship Securities Company might have the \$4,000,000 cash with which to pay the U. S. Shipping Board, a third wholly owned subsidiary had been organized by The Alpha Corporation; this subsidiary was known as The Delta Securities Company. The Delta Securities Company issued \$4,500,000 of ten-year serial notes, bearing interest at 7% per annum; each note was guaranteed, by indorsement thereon, by The Alpha Corporation. The net proceeds of these notes amounted to \$4,025,000; this was advanced on open account to The Chi Steamship Securities Company, which, in turn, paid in full the purchase price of the mortgage.

This was the situation when you took up the audit of the accounts for the fiscal year ended December 31, 1921. For pur-

poses of a balance sheet audit, when a consolidated balance sheet is to be given, what verification should be made of the above items in the several sets of books? What captions should appear in the consolidated balance sheet, and at what amounts should they be shown?

PROBLEM 76

WILLYS-OVERLAND COMPANY

Statement of Resources Provided and Disposition Thereof

The Willys-Overland Company's published consolidated balance sheets for two fiscal years ended December 31 are given below :

(Note: \$000.00 omitted)

<u>Assets</u>	<u>1919</u>	<u>1920</u>
LAND, BUILDINGS, MACHINERY AND EQUIPMENT:		
Land	\$ 2,758	\$ 3,786
Buildings	19,114	42,649
Machinery and equipment	13,737	
Tools, dies, patterns and drawings	6,710	3,954
Furniture and fixtures	609	Included Above
Automobile and truck equipment in service	312	
Leasehold investments	249	245
Totals	\$ 43,489	\$ 50,634
Deduct: Reserve for depreciation and accruing renewals	6,146	
	\$ 37,343	\$ 50,634
GOODWILL, PATENTS, TRADE MARKS, ETC.	14,060	14,060
Total property investment	\$ 51,403	\$ 64,694
INVESTMENTS IN AND ADVANCES TO AFFILIATED COMPANIES		
NOT WHOLLY OWNED	17,665	12,149
DEFERRED INSTALMENT NOTES RECEIVABLE		1,417
CURRENT ASSETS:		
Inventory of raw and worked materials, supplies, unassembled parts, service stock and cars, on hand and in transit	38,717	35,310
Balance due from European Distributing Agent	426	697
Accounts receivable, less reserves	3,906	2,520
Notes receivable	1,529	1,912
Investments in Liberty Bonds	1,153	96
Miscellaneous investments	876	664
Cash in banks and on hand	12,267	4,691
DEFERRED CHARGES TO FUTURE OPERATIONS	791	444
	<u>\$128,733</u>	<u>\$124,594</u>

	<u>Liabilities</u>	<u>1919</u>	<u>1920</u>
CAPITAL STOCK:			
7% cumulative preferred stock		\$ 8,894	\$ 8,878
7% cumulative convertible preferred stock		14,045	13,171
Common stock		39,550	54,290
Total capital obligations		<u>\$ 62,489</u>	<u>\$ 76,339</u>
CURRENT LIABILITIES:			
Notes payable		30,360	24,289
Accounts payable		9,220	1,745
Salaries and wages accrued		1,123	176
Dealers' and customers' initial payments		707	707
Taxes and interest accrued		708	579
Provision for repairs under guarantee			200
Preferred stock dividend, payable January 1		401	
Provision for price adjustments			1,105
Provision for refund certificates			68
RESERVES:			
For redemption of preferred stock		1,828	
For contingencies			7,500
For difference between cost and market value of materials contracted for but not received			2,250
For surplus inventory, etc.			1,500
SURPLUS		<u>21,897</u>	<u>8,136</u>
		<u>\$128,733</u>	<u>\$124,594</u>

The income account showed net income for the year of \$2,940. In addition, the Surplus account was credited during the year for \$12,544 arising from a revaluation of properties, and for \$2,716 previously appropriated for the redemption of the preferred stock, and from redeeming the preferred stock at a discount. Dividends of \$3,113 were declared and paid during the year. Inventories were written down \$6,920 and investments in affiliated companies were written off \$6,932. Other miscellaneous charges against surplus amounted to \$3,746.

Prepare a reconciliation of surplus for the year intervening between the two balance sheets. Next construct a statement showing the changes in the financial position of the company for the intervening year; this statement should be in form to be presented to the executives of the business.¹

¹ See Jackson, *Audit Working Papers*, pp. 46-47 and exhibits; Hatfield, *Accounting*, pp. 460-470.

PROBLEM 77

BROWNE, SMITH & CO.

Forms of Audit Certificates

Joseph E. Browne and Albert T. Smith, both Certified Public Accountants of the State of New York, formed a partnership as of January 1, 1924 for the public practice of accountancy. The partnership was known as Browne, Smith & Co., Certified Public Accountants, and the location chosen for the office of the newly formed firm was 120 Broadway, New York City. Both Mr. Browne and Mr. Smith had been associated for a number of years with leading firms of public accountants, and each had profited, to the extent of his ability, from his previous employment; each had had his major experience with a different firm of prominent accountants.

Upon the formation of the new partnership and the opening of the practice office, both Browne and Smith recognized that, among many other things, the firm must decide upon a general form of certificate to be used in certifying the accounts of clients. Each had certain ideas regarding the matter, based largely upon his own previous experience, but each also respected fully the other's experience and views; it was accordingly decided that Mr. Browne should examine a number of certificates, and should bring together a group of these from which a more or less standard form of certificate might be devised.

Mr. Browne accordingly proceeded to examine the published reports of many leading corporations, and from these he chose those certificates, or a sufficient number of them to serve his purpose, which he believed were satisfactory. In accordance with custom, he grouped the certificates into two groups, namely, short certificates, and descriptive or "long" certificates; the certificates chosen were as follows:

No. 1

TO THE STOCKHOLDERS OF THE CENTRAL LEATHER COMPANY:

We have examined the books of the Central Leather Company and its Subsidiary Companies for the year ending December 31, 1923, and We

CERTIFY that in our opinion the Balance Sheet at that date fairly sets forth the financial position of the Company and that the relative Profit and Loss account is correct.

PRICE, WATERHOUSE & Co.

New York, February 19, 1924.

No. 2

We have examined the accounts of the Hood Rubber Company and the Hood Rubber Products Company, Inc., as at March 31, 1924, and we certify that, in our opinion, the above Consolidated Balance Sheet conservatively sets forth the financial position of the Companies in consolidation at that date.

LYBRAND, ROSS BROS. & MONTGOMERY
Accountants and Auditors

Boston, Mass., May 10, 1924.

No. 3

TO THE STOCKHOLDERS OF THE PIERCE-ARROW MOTOR CAR COMPANY:

We have examined the books of the Pierce-Arrow Motor Car Company for the year ending December 31, 1923, and WE CERTIFY that, in our opinion, the attached Balance Sheet fairly sets forth the financial position of the Company at that date, and the relative Profit and Loss account is correct.

PRICE, WATERHOUSE & Co.

New York, January 26, 1924.

No. 4

We have audited the books and accounts of the Continental Car Company, Inc., (of New York), and of its subsidiary companies for the year ended December 31, 1923, and Certify that, in our opinion, the above Consolidated Balance Sheet correctly sets forth the combined position of the Companies at December 31, 1923, and that the attached Summary of Earnings for the year is correct.

DELOITTE, PLENDER, GRIFFITHS & COMPANY
Auditors

New York City, January 30, 1924.

No. 5

We have audited the books and accounts of the Endicott-Johnson Corporation and of its subsidiary companies for the year ended December 31, 1923, and WE CERTIFY that the above Consolidated Balance Sheet and the accompanying statements of current surplus and profit and loss are correctly prepared therefrom, and are, in our opinion, properly drawn up to show the true financial condition of the combined companies on December 31, 1923 and the results of the operations of the year then ended.

TOUCHE, NIVEN & COMPANY
Public Accountants

New York, January 16, 1924.

No. 6

We hereby certify that the above Combined Statement of Assets and Liabilities and the accompanying Combined Statement of Income and Surplus Accounts of the Chile Copper Company and the Chile Exploration Company are in accord with their books and records as kept at the New York Office, which we have audited, and with the reports from Chile, which we have examined and believe to be correct, and, in our opinion, properly represent the combined financial condition of these companies at December 31, 1922, and their income and surplus for the year ended December 31, 1922.

LOOMIS, SUFFERN & FERNALD
Certified Public Accountants

New York, April 12, 1923.

No. 7

TO THE STOCKHOLDERS OF

THE AMERICAN BANK NOTE COMPANY:

We have examined the books of the American Bank Note Company for the twelve months ending December 31, 1923, and have accepted foregoing returns as certified by independent auditors.¹

WE CERTIFY that in our opinion the accompanying consolidated balance sheet is properly drawn up so as to show the true financial position of the American Bank Note Company at December 31, 1923, and the relative profit and loss and surplus accounts show correctly the results of the business for the twelve months ending on that date.

PRICE, WATERHOUSE & Co.

New York, February 23, 1924.

¹ There has been considerable discussion among accountants regarding the meaning of the words "audited" and "examined" as used in certificates of this kind. No uniformity of practice exists, but the modern view is probably as well stated in the following letter as anywhere; it is given herewith:

"Accountants have made some distinction between the word 'audited' and the word 'examined.' The word 'audited,' as applied to financial statements covering a period of time, meant that the auditor had verified all the transactions appearing in the accounts with supporting vouchers. It is now manifestly impossible for an auditor to vouch all of the transactions in the accounts of a large enterprise and therefore many accountants have leaned to the use of the word 'examined' rather than 'audited,' since the word 'examined' implies that the transactions represented in the accounts have been verified by tests rather than by a complete check of all vouchers and other supporting data.

"There is really no uniformity of practice in the use of the two words, but it is my opinion that the word 'examined' much more nearly covers the work of the accountant on the balance sheet audit of an enterprise than the word 'audited.' It is quite possible that if an accountant used the word 'audited' he might be held in a court of law to be responsible for not having detected minor defalcations, should such exist, which it would be almost impossible for him to find as a result of a balance sheet audit. It is quite clearly understood by most corporations that the public accountant who certifies the annual statements does not assume any responsibility for defalcations in the cash transactions which are supposed to be covered by the company's own internal audit or detailed check.

"My firm in the case of a balance sheet audit leans more and more to the use of the word 'examined' as distinguished from the word 'audited,' although I must confess that in a number of instances where we started using the word 'audited' many years ago we still continue to do so, and I think you will find the same thing is true of the practice of most of the other firms of accountants.

"You will understand, of course, that the use of the words 'We have examined' instead of 'We have audited' in an unqualified certificate in no way relieves the accountant of responsibility for the work which is outlined in the Federal Reserve Bulletin on balance sheet audits."

No. 8

We have audited the general books and accounts of the American Smelting & Refining Company for the year ended December 31, 1923, have examined the related records of original entry and supporting documents, including monthly reports received from their various plants, mines, and subsidiaries, and,

WE HEREBY CERTIFY that, in our opinion, the accompanying Consolidated General Balance Sheet and Summary of Consolidated Income and Profit and Loss correctly exhibit the consolidated financial condition of the companies and their consolidated income results for the year.

HASKINS & SELLS

New York, February 26, 1924.

No. 9

Detroit, October 22, 1923

TO THE DIRECTORS AND STOCKHOLDERS,
PACKARD MOTOR CAR COMPANY:

We have examined the books and accounts of the Packard Motor Car Company and its subsidiary companies for the fiscal year ending on August 31, 1923, and certify that the annexed consolidated Balance Sheet and Income Account are correctly prepared therefrom.

During the year only expenditures for actual additions and extensions of properties and equipment have been added to the property accounts, and adequate provision has been made for depreciation and accruing renewals.

Inventories of the stocks of finished motor carriages and trucks and stocks of materials, supplies and unassembled parts on hand as certified by responsible officials have been valued at or below cost, all factory or inter-company profits being eliminated.

We have verified by actual count or by certificates obtained from the depositaries the cash and bank balances and securities owned, and have satisfied ourselves that full provision has been made for bad and doubtful accounts receivable and for all ascertained liabilities. The amount carried forward as deferred charges to future operations represents items which are reasonably and properly chargeable against the profits of future years.

WE CERTIFY that, in our opinion, the Balance Sheet is properly drawn up so as to show the financial position of the combined companies on August 31, 1923, and the relative Income Account fairly states the result for the fiscal year ending on that date.²

PRICE, WATERHOUSE & Co.

Public Accountants

² The first eight certificates shown are described as "short" certificates; this certificate and those that follow are known as "descriptive" or "long" certificates. The "long" or descriptive certificate, in addition to certifying to the accuracy of the accounts, states briefly the main verification work done to determine that the statements presented are true and correct.

No. 10

We have audited the books and accounts of the United States Rubber Company and its subsidiary companies for the year ended December 31, 1922, excepting those of certain of the foreign subsidiaries, as to which we have accepted reports of other accounting firms and, in some instances, reports of the companies.

The buildings and machinery owned by the Company had a total appraised value at December 31, 1922, after deducting depreciation accrued to that date, which was materially in excess of the value at which they are carried on the books, although depreciation was not fully provided for in connection with the operations of the year 1922; and

WE HEREBY CERTIFY that, subject to the foregoing, the accompanying general balance sheet, in our opinion, correctly sets forth the financial condition of the companies on December 31, 1922, and that the figures relating to the income and surplus accounts referred to in the text of the Chairman's report are correct.³

HASKINS & SELLS

Certified Public Accountants

New York,
March 8, 1923

No. 11

CERTIFICATE OF AUDITORS

New York, March 7, 1924

TO THE PRESIDENT AND DIRECTORS OF THE
BETHLEHEM STEEL CORPORATION:

We have examined the books and accounts of the Bethlehem Steel Corporation and its Subsidiary Companies for the year ended December 31, 1923, and find that the balance sheet at that date and the relative income account are correctly prepared therefrom.

During the year only actual additions have been charged to property account, and the provision for depreciation, obsolescence and depletion is, in our opinion, fair and reasonable.

The inventories of stocks on hand, as certified by the responsible officials, have been valued at prices not in excess of cost or market, and the accounts and bills receivable are, in our opinion, good and collectible. Full provision has been made for all ascertainable liabilities, and we have verified the cash and securities by actual inspection or by certificates from the depositaries.

³ This certificate is not so much a "descriptive" certificate as it is a "qualified" certificate. The reader should carefully note the several qualifications, and observe the clear-cut manner in which they are set forth for the information of any one who may peruse these statements.

The deferred charges represent expenditures reasonably and properly carried forward to the operations of subsequent years.

We certify that, in our opinion, the balance sheet is properly drawn up so as to show the financial position of the combined Companies on December 31, 1923, and the relative income account fairly states the results for the fiscal year ended at that date.

PRICE, WATERHOUSE & Co.

No. 12

40 Exchange Place, New York,
March 15, 1924

TO THE BOARD OF DIRECTORS OF THE
GENERAL ELECTRIC COMPANY,
120 Broadway, New York.

Dear Sirs:

We have examined the books and accounts of the General Electric Company for the year ended December 31, 1923, and hereby certify that the Condensed Profit and Loss account and Balance Sheet appearing on pages 13-15 of this report are in accordance with the books and, in our opinion, correctly record the results of the operations of the Company for the year and the condition of its affairs as at December 31, 1923.

We have verified the cash and securities by actual count and inspection or by certificates which we have obtained from the depositaries. The valuations at which the investment securities are carried have been approved by a Committee of the Board of Directors and, in our opinion, are conservative. Our audit has not included the examination of the accounts of certain of the companies which are controlled through stock ownership, but Balance Sheets of these companies have been submitted to us.

We have scrutinized the notes and accounts receivable and are satisfied that full provision has been made for possible losses through bad and doubtful debts.

Certified inventories of merchandise, work in progress, and materials and supplies have been submitted to us and we have satisfied ourselves that these inventories have been taken in a careful manner, that full allowance has been made for old or inactive stocks, and that they are conservatively stated on the basis of cost or market, whichever is lower. Provision has also been made for possible allowances or additional expenditures on completed contracts.

Expenditures capitalized in the property and plant accounts during the year were properly so chargeable as representing additions or improvements. Ample provision has been made in the operating accounts for repairs, renewals and depreciation, as also liberal reserves for contingencies.

Yours truly,

MARWICK, MITCHELL & Co.

No. 13

CERTIFICATE OF ACCOUNTANTS

New York, February 6, 1924

TO THE STOCKHOLDERS OF THE
AMERICAN LOCOMOTIVE COMPANY:

We have examined the books of the American Locomotive Company and its subsidiary companies, the Montreal Locomotive Works, Limited, and the American Locomotive Sales Corporation, for the year ending December 31, 1923, and find that the accompanying consolidated balance sheet at that date and the relative income account are correctly prepared therefrom.

The charges during the period to property account and to reserve for additions and betterments represent only actual additions and sufficient provision has been made for accruing renewals and depreciation.

The valuations of the stocks on hand, as shown by inventory certified by responsible officials, have been carefully made at prices not in excess of cost or market and due allowance has been made for old or inactive stocks. Full provision has been made for bad and doubtful accounts and bills receivable and for all ascertainable liabilities. We have verified the cash and securities by actual inspection or by certificates from the depositaries, and

WE CERTIFY that, in our opinion, the balance sheet is properly drawn up so as to show the financial position of the American Locomotive Company and its subsidiary companies at December 31, 1923, and the relative income account is a fair and correct statement of the net earnings for the fiscal year ending at that date.

PRICE, WATERHOUSE & Co.

No. 14

CERTIFICATE OF INDEPENDENT AUDITORS

March 25, 1924

TO THE STOCKHOLDERS OF THE INTERNATIONAL PAPER COMPANY:

Dear Sirs:

We have examined the books of the International Paper Company for the year ended December 31, 1923, and certify that the accompanying Balance Sheet at that date is in accordance with their books, and correctly sets forth the financial condition of the Company, and that the Profit and Loss Statement correctly states the result of operations for the year.

During the period only actual expenditures for new property have been charged to Property Account, and adequate provision has been made

for depreciation; all losses for bad and doubtful accounts have been provided for.

The item of Deferred Assets represents expenditures properly chargeable to future operations.

Actual cash on hand has been verified, and all securities have been accounted for. The values of securities as carried on the books of the Company are, we believe, conservative.

The figures as ascertained by our audit have been consolidated with statements of subsidiary Companies, and in our opinion the Consolidated Balance Sheet and Consolidated Profit and Loss Statement correctly exhibit the financial condition of the Companies and their consolidated income results for the year.

F. W. LAFRENTZ & Co.
Public Accountants

No. 15

Chicago, May 1, 1924

THE BOARD OF DIRECTORS,
INTERNATIONAL HARVESTER COMPANY,

Chicago, Illinois.

We have audited the books, accounts and records of the International Harvester Company and of its affiliated companies located in the United States, Canada, and certain European countries, and have examined the annual reports of all other affiliated companies for the year ended December 31, 1923.

We have examined the charges to capital accounts, have verified the cash and other current assets at December 31, 1923, including the inventories of raw materials and supplies, work in process, and finished products, and have verified the Income and Profit and Loss accounts.

We find that the Company has valued raw materials and supplies, work in process of manufacture and finished products at cost or market, whichever was lower, and has made reasonable provision for depreciated stocks and decline in inventory values.

The Company has pursued a conservative policy in its charges to capital accounts, has valued its foreign current assets at prevailing exchange rates, or less, has set up adequate reserves for depreciation and for possible losses, and has made provision for all known liabilities.

WE HEREBY CERTIFY that, in our opinion, the Combined Balance Sheet and the Income Account submitted herewith, reflect the true financial condition at December 31, 1923, and the results from operations for the year.

HASKINS & SELLS.

No. 16

CERTIFICATE OF INDEPENDENT AUDITORS

New York, March 12, 1924

TO THE STOCKHOLDERS OF THE UNITED STATES STEEL CORPORATION:

We have examined the books of the United States Steel Corporation and Subsidiary Companies for the year ending December 31, 1923, and certify that the balance sheet at that date and the relative income account are correctly prepared therefrom.

The charges to property account during the year cover only actual additions and extensions to the properties and plants, and the provision made for depletion and depreciation is, in our opinion, fair and reasonable. The item of deferred charges represents expenditures reasonably and properly carried forward to operations in subsequent years.

The valuations of the stocks of materials and supplies on hand, as shown by inventories certified by the responsible officials, have been carefully made at prices not in excess of cost or market, and, as stated in the directors' report, a substantial reserve has been deducted from the values so determined. Full provision has been made for bad and doubtful accounts receivable and for all ascertainable liabilities.

We have verified the cash and securities by actual inspection or by certificates from the depositaries, and are of opinion that the marketable bonds and stocks included in current assets are worth the value at which they are stated in the balance sheet, and

WE CERTIFY that, in our opinion, the balance sheet is properly drawn up so as to show the financial position of the Corporation and Subsidiary Companies on December 31, 1923, and the relative income account is a fair and correct statement of the net earnings for the fiscal year ending at that date.⁴

PRICE, WATERHOUSE & Co.

Study carefully the above certificates, and determine whether or not each contains all essential information. Discuss the characteristics of a good certificate; prepare a form of short certificate and also a descriptive certificate which Messrs. Browne, Smith & Co. may adopt as a standard for the certification of the accounts of clients. Preferably, which type of certificate, "short" or "descriptive," would you use in certifying a client's accounts? Why? Discuss.

⁴ In the case of the United States Steel Corporation a very short certificate is also attached to the balance sheet and to the income account, making three certificates all-told. So far as the author is aware this does not occur in the case of any other certified American balance sheet.

PROBLEM 78

WILSON & CO., INC.

Qualifications in Auditor's Certificate

The certified consolidated balance sheet of Wilson & Co., Inc., and its subsidiary companies at December 29, 1923 is shown on page 369.

Attached to the balance sheet was the certificate of the independent auditors, as follows:

ACCOUNTANT'S CERTIFICATE

We have examined the books and accounts of Wilson & Co. Inc. and its domestic and South American subsidiaries and affiliated Companies for the year ending December 29, 1923 and have had produced to us the audited statements of the remaining foreign subsidiary Companies. The Assets and Liabilities of subsidiary Companies other than the South American Companies are embodied in the above Balance Sheet. South American and Affiliated Companies are treated as investments. The net Current Assets included in Investments in South American Companies are stated at book values converted at standard rates of exchange and we have satisfied ourselves that the Exchange Reserve provided is sufficient to adjust such Current Assets to current rates of exchange as at December 29, 1923. In accordance with the decision of the Directors, no charge for depreciation of plants has been made during the year. We certify that upon the foregoing basis the Balance Sheet is in our opinion correctly prepared so as fairly to set forth the financial position of the Companies at December 29, 1923.

PRICE, WATERHOUSE & Co.
56 Pine Street, New York

March 14, 1924

What qualifications are there in the above certificate of the independent auditors? What is the significance of each qualification?¹ What criticisms, if any, do you have of the form and content of the balance sheet as certified?

¹ See George O. May, "Qualifications in Certificates", *Journal of Accountancy*, Vol. XX (October, 1915), pp. 248-259; R. H. Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 466-468.

WILSON & CO., INC., AND ITS SUBSIDIARY COMPANIES
CONSOLIDATED BALANCE SHEET, DECEMBER 29, 1923

ASSETS		LIABILITIES	
PROPERTY ACCOUNTS:		CAPITAL STOCK:	
Plants and Equipment.....	\$46,117,093.32	Preferred:	
Less—Mortgages payable and purchase money obligations.....	478,500.00	Authorized and Issued.....	\$12,000,000.00
	\$45,638,593.32	Outstanding.....	\$10,079,000.00
Trade Marks, Patents, Goodwill, etc.....	11,224,186.02	Common (without par value):	
		Authorized, 700,000 Shares	
		Outstanding, 202,181 Shares.....	20,000,000.00
Investment in Affiliated Companies not Wholly Owned....	\$ 56,862,779.34	Bonded Indebtedness	
		First Mortgage 6%, due 1941.....	\$22,956,000.00
Investment in South American Companies (Common Stock Wholly Owned) Including Net Current Assets of \$4,426,982.03.....	12,731,489.80	Convertible 6%, due 1928.....	15,085,000.00
		Convertible 7½%, due 1931.....	9,136,000.00
Merchandise, including Consignments, less Drafts drawn thereagainst.....	12,208,219.49	Accrued Interest on Bonds.....	47,177,000.00
		Notes Payable.....	698,323.75
Accounts and Notes Receivable, Including Claims against U. S. and British Governments.....	13,147,040.72	Accounts Payable and Other Liabilities.....	16,694,000.00
		Reserves against Foreign Exchange, Claims and Contingencies.....	3,314,010.41
Miscellaneous Securities (Including \$1,407,000 par value of Company's six per cent Convertible Bonds valued at market).....	17,803,113.56		3,388,481.31
Cash.....	1,457,817.52	SURPLUS:	
	5,507,805.77	Balance at December 31, 1922.....	\$18,431,406.60
Interest, Insurance, Bond Discount and Expense, etc., Prepaid or Deferred.....	1,803,025.55	Add:	
	\$121,521,291.75	Profit on Operations of the year 1923 before providing for Depreciation.....	2,450,866.43
		Deduct:	
		Dividends paid on Preferred Stock...	\$20,882,273.03
			711,796.75
			20,170,476.28
			<u>\$121,521,291.75</u>

Note: Dividend of 1¼% on Preferred Stock declared November 19, 1923, payable January 2, 1924.
Contingent Liability in respect of guaranty of Affiliated Companies notes payable \$2,970,000.00

PROBLEM 79

CANTABRIA RUBBER COMPANY

Decline in Value of Inventory After Close of Fiscal Period

The Cantabria Rubber Company, located in Akron, Ohio, manufactures automobile tires and various other kinds of rubber goods. Included in its inventory of raw material at the close of its fiscal year, December 31, 1925, was approximately 5,000 tons of ribbed, smoked sheets. This material had been purchased during the months of October, November, and December at prices approximating 98 cents per pound during October, 102 cents per pound during November, and 100 cents per pound during December. The market price for ribbed, smoked sheets, spot, at New York on December 31, 1925 was 89 cents per pound.¹

The accounts of the company were audited annually by Messrs. Jordan, Brown & Co., of Cleveland, Ohio. The audit verification work was completed during the latter part of February, during which time prices of crude rubber had fallen rather rapidly. The average price of ribbed, smoked sheets, spot, at New York² for January was approximately 79.6 cents while during February prices fell to 62.1 cents. The question arose, therefore, whether or not, in certifying the accounts of the company as of the close of the fiscal year December 31, 1925, any notice should be taken of the drop in prices which had occurred during January and February, 1926.

The senior in charge of the audit discussed the matter with the officials of the company before leaving Akron and they expressed themselves very strongly as desiring that no reference be made of this fact. Upon returning to Cleveland the matter was

¹ *The India Rubber World*, January 1, 1926, p. 237.

² *Crude Rubber Prices* (1927 Annual Statistical Bulletin, January 20, 1927, p. 70). Ribbed, Smoked Sheets, Spot, at New York:

1925		AVERAGE		1926	
October		99.6¢		January	 79.6¢
November		104.8¢		February	 62.1¢
December		100.0¢		July	 41.3¢
				December	 38.2¢

discussed with the principals of the firm. Mr. Jordan held the opinion that inasmuch as the audit was for the fiscal year ending December 31, 1925, and since the inventory of crude rubber was valued at cost or market whichever was lower as of that date, the balance sheet which the firm contemplated certifying correctly set forth the financial position of the Cantabria Rubber Company as at December 31, 1925. He maintained that whether the market for raw materials had increased or decreased since the close of the fiscal period did not alter this fact.

Mr. Brown, on the other hand, believed that some reference should be made in the accounts, or most certainly in the report accompanying the accounts, regarding this rather severe drop in inventory values during the first two months of 1926. He maintained that even though the balance sheet might correctly set forth the financial position of the company at December 31, 1925 without such reference, nevertheless it was important that creditors and bankers, and stockholders as well, be unmistakably informed that the inventory which was on hand at December 31, 1925 had become very much less valuable because of the severe drop in market prices.

To this Mr. Jordan replied that if the balance sheet showed the inventory at cost or market whichever is lower at December 31, 1925, bankers and creditors, and intelligent stockholders as well, would know that there had been a heavy decline in the value of crude rubber during January and a further severe decline during February; he maintained that it therefore was not necessary in stating the accounts to call attention specifically to this condition. He even believed that it was unnecessary to refer to the decline in market prices in the report to the client, and that any reference to it in the accounts themselves was wholly unnecessary.

How shall the matter be handled in certifying the annual accounts?³

³ The following excerpt is from the letter of a leading public accountant, with regard to the treatment in the certificate or in the report of losses arising after the date of the balance sheet but before the date of the certificate or report:

"With regard to . . . the accountant's responsibility for failure to provide for losses arising after the date of the balance sheet but before the date of the certificate, this is of course one of the most difficult questions with which we have to deal. It is impossible to lay down any hard and fast rule in such cases, but, generally speaking, I think that any accountant would feel called upon to make some reference to a condition coming to his notice during the intervening time which would inevitably result in very serious loss to the

PROBLEM 80

THE JONES-SMITH COMPANY

Certificate Attached to Audited Balance Sheet

The Jones-Smith Company had its books audited semi-annually by Beaver, Jensen & Company, Certified Public Accountants; as a result of each audit the company received a certified balance sheet which it was accustomed to present to its bank as a basis for loans. The customary audit was made for the half-year ended October 31, 1928, and the following certificate was attached to the balance sheet:

WE HEREBY CERTIFY that we have examined the books and accounts of The Jones-Smith Company for the six months ended October 31, 1928, and certify that the above balance sheet at that date is correctly prepared therefrom. The inventories on hand, as certified by responsible officials of the company, have been priced at market value. We have verified the Cash and Securities by actual inspection or by certificates from the various depositories. On the above basis, we certify that in our opinion the Balance Sheet is properly drawn up so as to show the true financial position of The Jones-Smith Company at October 31, 1928.

(Signed) BEAVER, JENSEN & COMPANY
Certified Public Accountants

St. Louis, Missouri,
November 27, 1928.

The balance sheet bearing the above certificate was submitted to the lending bank by The Jones-Smith Company; the banker severely criticized the statement, and particularly the auditor's

company. For instance, if a manufacturing company's main or only plant were destroyed by fire and did not happen to be covered by insurance, I think the accountant should make some reference to it. There are practical difficulties, however, which the accountant would meet in inquiring into the effect of a drop in market price of raw materials between the date of the balance sheet and the date of the certificate. He would have to make a very full investigation into the amount of the commitments and also into the amount of the firm sales orders which, of course, might substantially cover the materials under purchase contract. I think it would be unfair to condemn any accountant for not referring in his certificate to such a condition without knowledge of all the circumstances in each particular case.

"There is a tendency for the credit men of the banks to endeavor to assign an undue proportion of the responsibility for credit risks to the accountant. Many of them would like to be able to take the accountant's certificate or report without any investigation whatever of their own; whereas, there are many other factors affecting the credit of a company which the credit man should inquire into but which do not come within the scope of the accountant's regular work. Some of them could be inquired into by the accountant if he received specific instructions to do so, but the bank credit men are usually very loath to ask their customers to instruct the accountant to undertake any work outside of the regular routine, and it is of course manifestly impossible for the accountant to undertake such work without definite instructions."

certificate because, although more than one-half of the quick assets of the business was represented by accounts receivable, no mention of the accounts receivable or of their real content was made in the certificate. Upon further questioning and examination by the bank it was ascertained that considerably more than half of the accounts receivable was represented by billings of merchandise to retail stores operated by The Jones-Smith Company.

Was the auditor negligent in failing to show the "billings of merchandise to retail stores" as a separate item in the balance sheet? Should specific mention of this amount have been made in the auditor's certificate? Give reasons for your answers.

PROBLEM 81

ROBERT MORRIS ASSOCIATES

Miscellaneous Comments re Auditors' Certificates

The Robert Morris Associates, an association of bank credit men, has for a number of years had a special committee on co-operation with public accountants; this committee, together with a corresponding committee from the American Institute of Accountants, has accepted as one of its tasks the improvement of financial statements, and particularly of the certificates of audit attached thereto. As a part of its study the committee collected a large number of auditors' certificates, some of which appeared to be faulty in various respects; some of these certificates, together with the comments of the bankers thereon, are reproduced in the materials following:

(a) The balance sheet of a certain company was certified as of December 31, 1920, thus:

I hereby certify that the above is a true and correct transcript of the Assets and Liabilities appearing on the books of the....., on December 31, 1920.

(Signature of auditor)

The same certification appeared on the balance sheet of January 1, 1920.

(b) The balance sheet of as of December 31, 1920, was compiled by Messrs. While they do not state that they are certified public accountants, they are listed as accountants in the directory. They certified to the balance sheet as follows:

We certify that the Balance Sheet herewith presented is a true copy of the Assets and Liabilities of....., as on their books as of December 31, 1920.

(Signed)

This certificate is signed by Mr., who, besides being a member of the firm of above-mentioned accountants, is the secretary of the company.

(c) Another certificate of audit attached to a balance sheet read as follows:

We have made a superficial examination of the books of the firm of at the close of business December 31, 1920, and from the trial balance we have prepared the above condensed balance sheet, which in our opinion exhibits a correct view of the financial condition of the partnership at the date named, according to information and explanations given us, and as shown by the books.

(Auditor's signature)

The banker commented on this as follows: "In checking the balance sheet to which this certificate was attached I found several pertinent corrections, and while the auditor has safeguarded himself quite carefully in the phraseology of the certificate, I could not help but feel that in dressing up the balance sheet with all neatness he took money for his services which in my humble judgment was not earned."

(d) Another certificate read as follows:

We hereby certify that the above is a true statement of Assets and Liabilities as disclosed by the Company's books as of April 30, 1921.

(Signed by auditor)

(e) To the balance sheet of Company was attached the following statement or certificate:

We hereby certify, and would respectfully report: (1) That we have obtained all the information and explanations we have requested; (2) That we have audited the books and accounts of..... Company for the fiscal year ending the first day of March, 1921, and we have found them to be correct; and (3) That, in our opinion, the foregoing statement is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as of the first day of March, 1921, according to the best of our information and the explanations given us, and as shown by the books of the company.

(Signed)

The banker took exception to the clause "according to the best of our information and the explanations given us."

(f) Still another balance sheet was certified as follows:

We hereby certify that we have audited the books and records of and that, in our opinion, based upon the records examined and information obtained by us, the above balance sheet is drawn up so as to correctly set forth the financial condition of the company at the close of business December 31, 1920.

(Signed)

(g) Another certificate read:

We hereby certify that the above statement correctly sets forth the facts as to the financial position of..... on July 31, 1920, as they are shown in the books of account of the said company at that date.

(Signature of auditor)

(h) The balance sheet of Company, as of December 31, 1922, was certified to by, certified public accountants; the certificate reads:

We certify that the above consolidated condensed statement is in accordance with the books and, in our opinion, sets forth the true financial condition of the company subject to commitments, possible adjustments for Federal Tax Returns, etc.

(Signature of accountants)

(i) The balance sheet of was certified thus:

We have audited the books and accounts of..... for the fiscal year ended January 31, 1921, and those of.....

.....for the year ended December 31, 1920, and hereby CERTIFY that the above consolidated statement is in accordance therewith and, in our opinion, sets forth a correct statement of the financial condition of the two companies. The inventories were valued on the same basis as in previous years, some prices being in excess of current market quotations, and others less. On the whole, however, the inventories were valued conservatively at prices less than what have been subsequently realized. There was written off during the year for obsolescence of merchandise stock the sum of \$118,926.71.

(Signed)

Discuss constructively the above certificates; point out the weaknesses in them, and show wherein they are satisfactory. Which certificates should be rejected, if any? Might any of them be used without change? Comment.

PROBLEM 82

MESSRS. JOHNSON, BROWN & Co.

Certification of Accounts Receivable Sold

Messrs. Johnson, Brown & Co., a partnership which has been engaged in business in New York City for the past twelve years, has during the last two years passed through a severe financial crisis. The partnership has suffered severe losses and the individual partners have been compelled to make additional contributions of capital in order to maintain their original investment.

While this additional capital has helped materially, it has not been sufficient to finance the business and it has been necessary to sell a large proportion of the accounts receivable. The accounts receivable have therefore been sold on the basis of 60% advanced against the accounts receivable purchased, while the remaining 40% will be remitted by the purchaser when the customer pays the account.

In the partnership books of account the Accounts Receivable account stands with a debit balance of 100X dollars while a separate account, Due to Purchaser, shows a credit balance of 60X dollars. The partnership in closing its books for the year has applied the above credit account against the total accounts receivable due from customers. The partners argue that the accounts receivable no longer belong to the firm, but that a 40%

equity in the accounts is due from the purchaser. It is therefore their desire that the balance sheet reflect only the 40% due on the accounts, and this they desire to have shown in the balance sheet as Accounts Receivable.

Upon taking up the annual audit of the accounts for the year ended December 31, 1928, you find the situation as outlined above. You feel that this matter is of primary importance and must be fully considered in certifying the accounts. You believe that the matter may be cared for by a footnote on the balance sheet, stating, in substance, that the total Accounts Receivable include X dollars representing 40% due on accounts receivable pledged, which amount would be remitted by the purchaser of the accounts when the customer has paid the account. This you consider to be the most satisfactory method of referring to the matter in case a certified balance sheet is to be rendered.

A second method, however, when the balance sheet is accompanied by a detailed report would be to state in the auditor's certificate, or across the foot of the balance sheet itself, that the balance sheet "when read in conjunction with the accompanying report" sets forth or fairly states the financial condition of the business. If this were done, the facts concerning the sale of the accounts receivable could be commented upon in the report under the heading "Accounts Receivable."

The client who is entirely honorable and desires to see the right thing done fears the effect of a balance sheet which would reflect the sale of its accounts. The partners have therefore asked you to prepare the accounts in any way you desire, but ask that you do not refer, if you can possibly keep from doing so, to the financing which has taken place.

Outline fully what position you would take and how you would be willing to certify the Accounts Receivable in this case.¹

PROBLEM 83

HARNED MANUFACTURING COMPANY

Inventories Certified at Fair Market Value

In the audit of the accounts of the Harned Manufacturing Company for the fiscal year ending March 31, 1928, the account-

¹ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., p. 113.

ants, Messrs. Chuzzlewit, Field & Co., 215 West Sixth Street, Los Angeles, prepared the balance sheet and certified to it as follows :

We have audited the accounts and records of the Harned Manufacturing Company for the year ended March 31, 1928, and have prepared the above balance sheet therefrom. The inventories of products, both manufactured and in process of manufacture, materials and supplies have been taken at a fair market value which is less than cost. On this basis WE CERTIFY THAT the balance sheet is correct, and fairly states the financial position of the Harned Manufacturing Company at that date.

(Signed) CHUZLEWIT, FIELD & Co.
Certified Public Accountants

Los Angeles, California,
May 5, 1928.

A copy of this balance sheet was submitted to the bank by the Harned Manufacturing Company. The banker was somewhat surprised at the wording of the certificate, which, he stated, "would impress one with the idea that the inventory was taken at market," whereas when a representative of the bank visited the factory of the company in March, 1928, he made inquiry relative to the market for the inventories and was told that the loss the company would show for the year would depend somewhat on the way the inventories were valued; the company officials had expressed themselves as feeling "that replacement cost would probably be too low as a basis," but they would not express an opinion regarding the price at which the inventories would be taken into the accounts.

The banker stated that "an arbitrary valuation would appear to have been placed upon the inventories which was far from conservative"; sometime later the banker again commented that "I should say that the inventory as certified to was not taken at a fair market value." The company later showed a substantial loss on the inventory; in a letter received by the bank from the treasurer of the company under date of October 29, 1928, the treasurer stated that "the placing of a price on the company's inventory at March 31, 1928 was largely a matter of estimate, inasmuch as there was only a nominal market existing at that date." The treasurer added that "the inventories as shown in the figures of September 30, 1928 are on a fair market basis."

The banker thereupon wrote to Messrs. Chuzzlewit, Field & Co. setting forth the above facts, and adding: "It would appear that if there was only a nominal market existing at March 31, 1928, as was apparently the case, you should not have certified to a fair market value."

Were the accountants in error in using a nominal market value in certifying the above accounts? Support your views.

PROBLEM 84

STANFORD MOTOR CAR COMPANY

Report and Accounts Submitted as Result of Audit

The books and accounts of the Stanford Motor Car Company, and of its subsidiaries and branches, have been audited annually for a number of years by Messrs. Audit, Examination & Co., 120 Broadway, New York City. The fiscal year of the companies ends on September 30, and it has been customary for the auditors to take up the examination of the accounts as soon thereafter as the several companies could get their books and records ready to be audited. Upon the completion of the audit each year, the auditors have prepared and certified a consolidated balance sheet and relative consolidated statement of profit and loss for the Stanford Motor Car Company and Subsidiary Companies; these consolidated statements were used chiefly for publication purposes.

At the request of the parent company, the auditors have then followed the practice of preparing detailed reports on their examination of the various companies' accounts. In these reports the accountants have endeavored to confine their remarks to essential facts, and to those things which it seemed especially desirable to bring to the attention of the executives of the several companies and branches.¹ Even so, however, the reports have

¹ "No arbitrary rule can be stated to determine which things are important, however, for their importance is dependent upon conditions which exist in each individual business. Good judgment on the part of the auditor, therefore, must be exercised to determine what shall be reported to the business under audit. The auditor should always remember that *the primary purpose of a report is to throw light on its subject-matter.*

"As a general rule it may be said that the size of the business and the familiarity of its executives with the practices and methods of professional accountants will determine somewhat the length of the report and the amount of detail to be included in it, as will also peculiar conditions or special characteristics of the business or of the person or

consumed considerable time in their preparation, so that it has been approximately two months after the companies' fiscal closing date before the reports were ready for delivery.

You are asked to study the accountants' report on the accounts of the parent company, the Stanford Motor Car Company, for the fiscal year ended September 30, 1928; this report is reproduced in full on pages 381-399 following. Observe the several divisions of the report, and discuss the characteristics of each. Do you feel that any fundamental information concerning the company's financial position, or its earnings for the period under review, is lacking; if so, what? Would you have included such information? Where? Would you have omitted something now included in the report, or would you have made the report longer to the extent of the added material? Discuss. Is the language of the report pleasing?² As a whole do you consider the report sufficiently "interesting" that a business man would read it in its entirety? If not, why not? How would you change it? Discuss.

persons who are primarily interested in it. Moreover, the audit in the case of a small business will ordinarily be more detailed than in the case of a large organization, probably because the internal accounting safeguards will not be so well developed in the smaller business.

"The auditor should not fail to give his opinion on matters arising in connection with his work through fear of incurring responsibility. It is comparatively easy, in such cases, merely 'to pass by on the other side,' but, in all cases where the object of the work is not confined to the certification of accounts already fully understood by the client, it may easily be that an expression of expert opinion on a single point will be of greater worth to the client than all the rest of the audit." See *The Accounting Review*, Vol. I, No. 3 (September, 1926), p. 50.

² "Paragraphs in the report should be neither so long that the central idea is difficult to grasp, nor so short that the impression of a fragmentary development of the thought is given. Short topic sentences, summary sentences, and sentences of transition may be used to advantage. Long, rambling, roundabout sentences should be avoided. Sentences which are short and simply-framed are the easiest to understand, though in determining the length of sentences the principle of variety should not be forgotten. There should never be any question concerning the grammatical construction of the sentences.

"The principle of simplicity applies to words and phrases as well. Heavy, polysyllabic words and cumbersome phrases should give way to simple words and idioms wherever possible. Slang and colloquialisms are always out of place in a report. *Simplicity of style never requires the use of an expression which is not in reputable standing.* Furthermore, a midway course between a wordy style on the one hand and undue brevity on the other will add much to the report. The facts should be made clear, but should be presented in as few words as possible.

"The tone of the report should be one of friendliness, but should show unmistakably that the auditor is interested primarily in presenting the exact truth. Sarcasm and flippancy are always to be avoided, while dignity and impersonality of tone are to be continually sought. These latter qualities can best be secured when the accountant expresses himself in his report directly to his client and in accordance with the canons of good taste. Clients are interested in facts and not the embellishments of the facts; these facts they must have if they are to correct their managerial sins of omission and commission." See *The Accounting Review*, Vol. I, No. 3 (September, 1926), p. 60.

AUDIT, EXAMINATION & CO.)

120 Broadway

NEW YORK

November 30, 1928

Mr. A. M. Napoleon, President,
Stanford Motor Car Company,
Buffalo, New York.

Dear Sir:-

In accordance with instructions received, we have made an audit of the books and accounts of the Stanford Motor Car Company and the following subsidiary companies and branches for the year ending September 30, 1928, viz.:-

Stanford Motor Car Company of New York
Stanford Motor Car Company of Chicago
Stanford Motor Car Company of Philadelphia
Stanford Motor Sales Company
Stanford Motor Car Company - Buffalo Branch
Stanford Motor Car Company - Detroit Branch

A certified consolidated balance sheet of the Stanford Motor Car Company and subsidiary companies as at September 30, 1928, to which our formal certificate is attached, has already been furnished for publication; a copy of this is submitted under separate cover, together with additional statements setting forth the financial position and the particulars of the surplus of each of the constituent companies. Since a separate report has been prepared on our audit of each of the subsidiary companies and branches, the report herewith submitted deals solely with the accounts of the parent company; in connection therewith we have prepared and annex hereto the following financial statements:-

Balance sheet, September 30, 1928
Statement of profits and income for the
year ending September 30, 1928
Supplemented by:
Statement of cost of sales
Statement of selling, general and
administrative expenses

Exhibit I

" II
" II-a
" II-b

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SCOPE OF WORK

Following the practice adopted in our previous audit, the examination was conducted along the lines of a general financial audit, embracing a verification of the assets and liabilities as at September 30, 1928 and of the profits and income for the year ending on that date; accordingly we did not make a detailed check of the cash transactions.

EARNINGS

The net factory profit of the Standard Motor Car Company (exclusive of the profits of the Buffalo Branch, which, it may be mentioned, are taken up on the books of the parent company each year), after deducting all expenses of the business, amounted to \$10,877,855.64 for the year ending September 30, 1928 as compared with \$5,275,262.86 for the previous fiscal year, an increase of \$5,602,592.78. The deduction for Federal income taxes amounted to \$1,554,000.00 for 1928 as against \$780,000.00 for 1927, an increase therein of \$774,000.00. Therefore, the factory profit, before deducting Federal taxes, amounted to \$12,431,855.64 during the fiscal year just ended as compared with \$6,055,262.86 during the previous year, an increase of \$6,376,592.78.

Particulars of sales, manufacturing costs and expenses for the year are shown in the statement of profits and income (Exhibit II) attached, supplemented by Exhibits II-a and II-b, a summary of which follows, together with a corresponding summary of the statement of profits and income for the year ending September 30, 1927, viz.:

<u>P a r t i c u l a r s</u>	<u>Year ending September 30</u>		<u>Increase or decrease</u>
	<u>1 9 2 7</u>	<u>1 9 2 8</u>	
<u>Sales, net:</u>			
<u>Main division:</u>			
<u>Carriages sold</u>	18,530	10,374	8,156
<u>Amount</u>	\$28,403,314.38	\$19,261,925.75	\$ 9,141,388.63
<u>Average</u>	\$1,532.83	\$1,856.75	\$323.92
<u>Forward,</u>	\$28,403,314.38	\$19,261,925.75	\$9,141,388.63

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<u>P a r t i c u l a r s</u>	<u>Year ending September 30</u>		<u>Increase or decrease</u>
	<u>1 9 2 7</u>	<u>1 9 2 8</u>	
Forward,	\$28,403,314.38	\$19,861,925.75	\$ 9,141,388.63
<u>Truck division:</u>			
Trucks sold	10,480	16,096	5,616
Amount	16,517,412.32	32,073,145.14	15,555,732.82
Average	\$1,576.03	\$1,992.61	\$416.52
<u>Service division:</u>			
Parts and repairs	3,677,417.80	9,255,764.27	5,578,346.47
Total sales	<u>\$48,598,144.50</u>	<u>\$60,590,835.16</u>	<u>\$11,992,690.66</u>
<u>Deduct - Cost of sales:</u>			
Carriages	\$24,352,139.14	\$16,280,025.95	\$ 8,072,113.19
Average	\$1,314.20	\$1,569.31	\$255.11
Trucks	12,291,816.96	23,965,984.82	11,664,167.86
Average	\$1,172.88	\$1,488.32	\$315.44
Service	2,915,357.22	7,371,530.31	4,456,173.09
Total cost	<u>\$39,559,313.32</u>	<u>\$47,607,541.08</u>	<u>\$ 8,048,227.76</u>
<u>Gross profit:</u>			
Carriages	\$ 4,051,175.24	\$ 2,981,899.80	\$ 1,069,275.44
Average	\$218.63	\$287.42	\$68.79
% to sales	14.26	15.48	
Trucks	4,225,595.36	8,117,180.32	3,891,584.96
Average	\$403.21	\$504.30	\$101.09
% to sales	25.58	25.31	
Service	762,060.58	1,884,233.96	1,122,173.38
% to sales	20.72	20.36	
Total	<u>\$ 9,038,831.18</u>	<u>\$12,983,294.08</u>	<u>\$ 3,944,462.90</u>
% to sales	18.60	21.43	
Profit on special type engines		1,974,000.00	1,974,000.00
<u>Less - Reserves against inven-</u> <u>tories</u>	1,037,096.18		1,037,096.18
Total gross profit	<u>\$ 8,001,735.00</u>	<u>\$14,957,294.08</u>	<u>\$ 6,955,559.08</u>
<u>Add - Other income</u>	1,007,455.89	833,908.48	173,547.43
Total profits and income	<u>\$ 9,009,190.89</u>	<u>\$15,791,202.54</u>	<u>\$ 6,782,011.65</u>
<u>Deduct - Selling, general, admin-</u> <u>istration and develop-</u> <u>ment expenses</u>	2,487,347.07	2,831,513.54	144,166.47
Balance, net profits from operations	<u>\$ 6,521,843.82</u>	<u>\$13,159,689.00</u>	<u>\$ 6,637,845.18</u>
<u>Deduct - Interest charges</u>	466,580.96	727,833.36	261,252.40
Balance, being factory profit before deducting Federal income tax - Forward,	<u>\$ 6,055,262.86</u>	<u>\$12,431,855.64</u>	<u>\$ 6,376,592.78</u>

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<u>P a r t i c u l a r s</u>	<u>Year ending September 30</u>		<u>Increase or decrease</u>
	<u>1 9 2 7</u>	<u>1 9 2 8</u>	
Forward,	\$6,055,262.86	\$12,431,855.64	\$6,376,592.78
<u>Deduct</u> - Federal income tax	780,000.00	1,554,000.00	774,000.00
Net factory profit, as per Exhibit II	\$5,275,262.86	\$10,877,855.64	\$5,602,592.78
<u>Add</u> - Profits of Buffalo Branch (after deducting its proportion- ate share of the reserve for income tax):			
Profit for the year	231,043.83	49,534.85	181,508.98
Adjustment of previous year's profits		56,868.99	56,868.99
Total net profits of the company available for dividends and other corporate purposes	<u>\$5,506,306.69</u>	<u>\$10,984,259.48</u>	<u>\$5,477,952.79</u>

It will be seen from the foregoing summary that during the year under review the sales of carriages fell off considerably, which was due to the curtailment of production of passenger cars, while, on the other hand, the sale of trucks increased. The total sales for the year were \$60,590,835.16 as compared with \$48,598,144.50 for the previous year, an increase of \$11,992,690.66 which is accounted for by the net increase in vehicle sales of \$6,414,344.19 and in service parts sales of \$5,578,346.47. Of the increase in factory profit before deducting Federal taxes, namely, \$6,376,592.78, the sum of \$1,974,000.00 represents profits on special type engines, leaving a balance of \$4,402,592.78, which may be accounted for thus:-

Increase in gross profits resulting from:

(1) Increase in average prices realized:

10,374 carriages @ \$323.92	\$3,360,346.08	
16,096 trucks @ 416.52	6,704,295.92	\$10,064,642.00

(2) Less - Increased manufacturing
and producing cost:

10,374 carriages @ \$255.11	\$2,646,511.14	
16,096 trucks @ 315.44	5,077,322.24	7,723,833.38
		\$2,340,808.62

(3) Greater volume of business:

Increased sales:

5,618 trucks @ \$403.21 (being gross
profit earned in 1927 season)

\$2,264,627.18

Forward,

\$2,264,627.18 \$2,340,808.62

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Forward,	\$2,264,627.18	\$2,340,808.62
<u>Less - Diminished sales:</u>		
8,156 carriages @ \$218.63 (being gross profit earned in 1927 season)	1,783,146.28	481,480.90
(4) Increase in gross profit on service sales due to a corresponding increase in volume of sales		1,122,173.38
Net increase in gross profits (exclusive of profit on special type engines)		\$3,944,462.90
<u>Add:</u>		
Decrease in reserves against inventories (i.e. charges in this respect for 1928 were absorbed in the cost of sales)		1,037,096.18
Together		\$4,981,559.08
<u>Deduct:</u>		
Decrease in other income	\$173,547.43	
Increase in selling, general, administration and development expenses	144,166.47	
Increase in interest charges	261,252.40	578,966.30
Balance, being factory profits exclusive of profit on special type engines and before deducting Federal taxes, as above referred to		\$4,402,592.78

The following statement, showing percentages of earnings on the common capital stock and on the common capital and surplus, together (i.e., after deducting from earnings the dividends paid on preferred stock) at the beginning of the respective periods, may be of interest:-

	<u>R a t i o t o</u>	
	<u>Common Capital stock</u>	<u>Common stock and surplus</u>
<u>Year ending September 30:</u>		
1927	34.28%	27.81%
1928	72.74%	48.91%

FINANCIAL POSITION

We submit below a statement of resources and funds provided during the year from revenue and other sources and the disposition and utilization of such resources, followed by a comparative summary of the current assets and liabilities constituting the working capital at September 30, 1927 and 1928, respectively:-

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Resources and funds provided:From revenue sources:

Net profit for the year ending			
September 30, 1928	\$10,984,259.48		
Add - Appropriation from earnings			
not involving cash outlays:			
For depreciation purposes	\$759,593.57		
For amortization of discount on gold notes	67,620.08	827,213.65	\$11,811,473.13

From subsidiary companies and branches in			
reduction of advances - net			295,449.40
Trustee stock adjustment			18,000.00

Total to be accounted for \$12,124,922.53

Disbursements therefrom:Expended on additions and extensions to properties:

Net additions	\$1,733,874.36		
Less - Real estate mortgage assumed	323,385.66	\$1,410,488.70	

Liquidation of bank loans 3,497,481.60

Cash dividends paid:

On preferred stock, 7%	\$672,000.00		
On common stock, 6%	852,458.00	1,524,458.00	6,432,428.30

Balance, being excess of resources and funds provided over disbursements therefrom, retained in the business as additional working capital, as shown below \$5,692,494.23

Comparative statement of current assets and liabilities

Particulars	At September 30		Increase or decrease
	1927	1928	
Inventories	\$23,464,159.61	\$23,270,422.48	\$ 193,737.13
Notes and accounts receivable	3,325,313.17	5,410,181.78	2,084,868.61
Miscellaneous investments	22,834.50	201,399.30	178,564.80
Liberty bonds and other United States securities		5,087,427.60	5,087,427.60
Cash	790,113.92	2,517,235.04	1,727,121.12
Total current assets	\$27,602,421.20	\$36,486,666.20	\$ 8,884,245.00
Deduct - Current liabilities (exclusive of borrowed money) viz:			
Audited vouchers and miscellaneous liabilities	\$5,452,446.13	\$7,227,949.30	\$1,775,503.17
Reserve for Federal income taxes	850,151.00	1,607,853.74	757,702.74
Together	\$6,302,597.13	\$8,835,803.04	\$2,533,205.91
Net current assets	\$21,299,824.07	\$27,650,863.16	\$6,351,039.09
Add:			
Prepaid items	839,049.60	180,504.74	658,544.86
Total working capital, showing increase in latter year referred to above	\$22,138,873.67	\$27,831,367.90	\$5,692,494.23

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Particulars	At September 30		Increase or decrease
	1927	1928	
Provided by:			
Stockholders	\$17,368,873.67	\$26,558,849.50	\$9,189,975.83
Bankers and creditors respectively	4,770,000.00	1,272,518.40	3,497,481.60
Working capital, as above	<u>\$22,138,873.67</u>	<u>\$27,831,367.90</u>	<u>\$5,692,494.23</u>

With regard to the stipulation under the indenture of trust covering the company's issue of three-year 5% gold notes that a certain ratio of quick assets to liabilities in respect of borrowed money should be maintained, the following statements, compiled in accordance with our interpretation of the clause relating thereto, shows that the requirements are fully complied with:-

Face amount of gold notes outstanding	\$6,000,000.00
All other indebtedness of the Stanford Motor Car Company and its subsidiary companies for borrowed money and loans (not including inter- company loans)	2,033,162.71
Together	<u>\$8,033,162.71</u>
Amount of quick assets required under the Trust Indenture (viz., twice the foregoing figures)	\$16,066,325.42
Actual amount of quick assets as per consolidated balance sheet	43,793,497.33
Difference, being excess over the requirements	<u>\$27,727,171.91</u>

The relation of the current assets to the total current liabilities at September 30, 1928 is as follows:-

Particulars	Stanford Motor Car Company and subsidiaries (per consolidated balance sheet)	Stanford Motor Car Company (per balance sheet of parent company)
Current assets	\$43,793,497.33	\$36,486,686.20
Current liabilities	11,126,004.99	10,108,321.44
Equivalent to a percentage of Or a basis of	393.61 3.9 to 1	360.96 3.6 to 1

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BALANCE SHEET

Turning now to the principal items appearing in the balance sheet, we have the following comments to make:-

LAND, BUILDINGS, MACHINERY, PLANT AND EQUIPMENT - \$14,441,179.16:

Land	\$ 1,127,957.33
Buildings	4,781,558.18
Machinery	3,071,155.38
Plant equipment	1,455,879.98
Factory fixtures	310,624.33
Tools, patterns and dies	2,777,165.63
Office furniture and fixtures	122,114.28
Service and traffic vehicles	103,666.47
Construction work in progress, etc.	691,057.58
Total	\$14,441,179.16

Expenditures on account of extensions and additions to properties during the year amounted to \$1,733,874.36 as shown in the following summary:-

<u>Particulars</u>	<u>Balance at</u> <u>Oct.1, 1927</u>	<u>Net</u> <u>additions to</u> <u>Sept.30, 1928</u>	<u>Depreciation</u> <u>written off</u> <u>during year</u>	<u>Balance at</u> <u>Sept.30, 1928</u>
Land	\$ 838,892.25	\$ 289,065.08		\$ 1,127,957.33
Buildings	4,855,909.59	168,444.06	\$242,795.47	4,781,558.18
Machinery	2,962,682.67	404,740.97	296,268.26	3,071,155.38
Plant equipment	1,506,521.37	100,010.73	150,652.12	1,455,879.98
Factory fixtures	310,339.13	31,319.11	31,033.91	310,624.33
Tools, patterns and dies	2,535,261.63	241,904.00		2,777,165.63
Office furniture and fixtures	129,236.00	5,801.87	12,923.59	122,114.28
Service and traffic vehicles	109,526.88	20,059.81	25,920.22	103,666.47
Construction work in process	216,528.85	472,528.73		691,057.58
Total	\$13,466,898.37	\$1,733,874.36	\$759,593.57	\$14,441,179.16

The additions during the year were verified by examination of vouchers, invoices, cost records and other documents, from which we satisfied ourselves as to the propriety of the charges.

The assets represented by the property accounts above stated as at October 1, 1927, while in agreement in the aggregate with the properties as enumerated on the balance sheet submitted as of that date, were reclassified

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subsequent to our audit of last year and the valuations thus obtained are used in the foregoing statement as the opening balances for the year under review.

The provisions for depreciation and accruing renewals of the factory buildings, fixtures, equipment and machinery, together with the maintenance charges for the year, are shown in the following statement:-

<u>Particulars</u>	<u>Buildings, fixtures and equipment</u>	<u>Machinery</u>	<u>Together</u>
Property investment:			
Average for the year	\$6,954,793.99	\$3,165,053.16	\$10,119,847.15
Depreciation provision	\$437,405.09	\$296,268.26	\$733,673.35
% to investment	6.29	9.36	7.25
Maintenance expenditures	323,328.06	506,294.34	829,622.40
% to investment	4.65	16.00	8.20
Depreciation and maintenance together	\$760,733.15	\$802,562.60	\$1,563,295.75
% to investment	10.94	25.36	15.45
Corresponding percentages for the year ending September 30, 1927	10.88	21.86	14.33

The tools, dies and patterns were not depreciated at a fixed rate, but the account representing these assets has been written down to the appraised value determined by the company. A statement has been prepared showing the changes in this account during the year, as follows:-

Balance at September 30, 1927	\$2,535,281.63
Additions	2,375,179.74
Together	\$4,910,441.37
Deduct - Amount written off	2,133,275.74
Balance at September 30, 1928	\$2,777,165.63

INVENTORIES - \$23,270,422.48:

No complete physical inventories have been taken since December 31, 1926. The above amount represents the book value of stocks on hand at September 30, 1928, with the exception of the stock of finished carriages and trucks valued at \$7,924,006.09 which was verified by the company by an actual count of vehicles.

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A brief summary of the stocks on hand is as follows:-

Raw materials and supplies in process	\$13,876,363.67
Raw materials and supplies in transit	86,616.40
Service stock and accessories (including parts on consignment)	1,403,536.33
Finished carriages and trucks on hand and on consignment	<u>7,924,006.09</u>
Total, as above	<u>\$23,270,422.48</u>

A comprehensive analysis of all inventory accounts was made by us whereby we satisfied ourselves as to the propriety of the charges and credits thereto.

In addition to the reserves created during the year to provide for the inevitable inventory shortages in quantities and the gradual obsolescence of service and excess stores in the aggregate amount of \$2,486,027.29, there was charged to operations at the end of the year an amount of \$752,559.71; accordingly, we are of the opinion that the inventories as now stated in the accounts are on a conservative basis.

The reserve of \$660,000.00 against inter-company profits in inventories of subsidiary companies established September 30, 1927 remains intact and is, in our opinion, sufficient for the purpose as applying to the inventories of September 30, 1928; therefore, no additional provision has been made in this respect.

ACCOUNTS AND NOTES RECEIVABLE - \$5,410,181.78:

Accounts receivable, less reserve	\$5,294,408.78
Notes receivable	115,773.00
Together	<u>\$5,410,181.78</u>

The notes receivable were examined by us during the course of the audit and the aggregate of the balances appearing in the accounts receivable ledgers was found to be in agreement with the respective controlling accounts. Inquiries were made as to the condition of the outstanding accounts, which, with the exception of a very small proportion, are considered good and collect-

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ible. A reserve has been provided for the accounts considered doubtful of collection.

MISCELLANEOUS INVESTMENTS - \$201,399.30:

The Buffalo Trust Company, 2,100 shares of an undivided interest in certain property, comprising letters, patent, invention, etc. (Radko Company)		\$ 11,760.00
Beech Stone Company stock, 24 shares of \$100.00 each		2,400.00
Loyola Rock Company stock, 120 shares of \$100.00 each		12,000.00
The United Machine and Welding Company, Stock - 20 shares of \$100.00 each	\$2,000.00	
Bonds - 10 bonds of \$100.00 each	<u>1,000.00</u>	3,000.00
Union Land Company, loan		6,000.00
Stanford Motor Car Company stock, 500 shares preferred stock	\$50,577.80	
5 " common stock	<u>554.40</u>	51,132.30
Stanford Motor Car Company, 5% gold notes of the par value of \$116,000.00		115,107.00
		<u>\$201,399.30</u>

The investments are stated at the amounts at which they were acquired; the stock certificates and the bonds representing the same were produced for our inspection.

LIBERTY BONDS AND U.S. TREASURY CERTIFICATES - \$5,087,427.60:

U.S. Treasury Certificates	\$3,480,000.00
Investments in Liberty Bonds	<u>1,607,427.60</u>
Together	<u>\$5,087,427.60</u>

The investment in Liberty Bonds and U.S. Treasury Certificates was verified by a count of the bonds and certificates in the custody of the treasurer of the company and by letters of confirmation from the depositaries holding for account of the company Treasury Certificates amounting to \$2,000,000.00.

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CASH IN BANKS AND ON HAND - \$2,517,235.04:

The composition of cash is as follows:-

In banks	\$2,424,938.45
Petty cash fund	18,000.00
Shop cashier's fund	60,000.00
Treasurer's special account	3,496.59
Certificate of deposit (carried in special investment account)	10,800.00
Total	\$2,517,235.04

The cash items were verified during the course of the audit by certificates obtained from the banks or by actual count and inspection.

DEFERRED CHARGES TO FUTURE OPERATIONS - \$256,561.89:

Prepaid taxes	\$128,345.36
Unexpired insurance	51,356.28
Miscellaneous charges	803.10
Total prepaid items	\$180,504.74
Unamortized portion of discount on debenture notes	76,057.15
Together	\$256,561.89

These items have been verified by us and are properly carried forward to be charged against subsequent operations.

FIVE PER CENT GOLD NOTES - \$6,000,000.00:

The total authorized issue of gold notes is \$9,000,000.00 of which \$6,000,000.00 is issued and outstanding and \$3,000,000.00 has been deposited with the First National Bank of Buffalo as collateral for the loan of \$2,500,000.00 hereinafter referred to. The trustee has furnished us with a certificate as to the amount of gold notes outstanding at September 30, 1928.

PURCHASE MONEY OBLIGATIONS - \$852,644.31:

The liability on account of purchase money obligations has been increased during the year by the sum of \$323,385.66, represented by two notes issued to Fuller & Jones, Inc. for \$150,000.00 and \$173,385.66, respectively,

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payable July 31, 1930 with interest at 6% per annum, in payment of buildings in St. Louis purchased on behalf of the Stanford Motor Sales Company.

CURRENT LIABILITIES - \$10,108,321.44:

We have ascertained, insofar as possible, that all known liabilities have been included in the attached accounts, comprising, among other items, the liability for materials in transit, accrued interest on gold notes and reserve for Federal income taxes.

The amount owed to the First National Bank of Buffalo of \$1,272,518.40 is the unpaid balance on a loan by the company of \$2,500,000.00, secured by \$3,000,000.00 of its 5% gold notes, as herein previously stated.

SURPLUS - \$16,386,772.60:

The surplus account is shown on the balance sheet (Exhibit I), from which it will be seen that the net addition to surplus during the fiscal year was \$9,459,801.48, arrived at as follows:-

Net profits for the year ending September 30, 1928		\$10,984,259.48
<u>Deduct - Dividends paid:</u>		
On preferred stock, 7%	\$372,000.00	
On common stock, 6%	<u>852,458.00</u>	1,524,458.00
		<u>\$ 9,459,801.48</u>

* * * * *

In conclusion, we take this opportunity of expressing our appreciation of the facilities extended to our representatives by the officials and staff of the company for the purpose of the audit.

Yours very truly,

(Signed) AUDIT, EXAMINATION & CO.

STANFORD MOTORBALANCE SHEETASSETSPROPERTY ACCOUNT:

<u>Land, buildings, machinery, plant and equipment</u>	
<u>at cost, less depreciation:</u>	
Land	\$1,127,957.33
Buildings	4,781,558.18
Machinery	3,071,155.38
Plant equipment	1,455,879.98
Factory fixtures	310,624.33
Tools, patterns and dies	2,777,155.63
Office furniture and fixtures	122,114.28
Service and traffic vehicles	103,666.47
Construction work in progress, etc.	<u>691,057.58</u>
	\$14,441,179.16
Rights, privileges, franchises, etc.	1.00
Total property investment	<u>\$14,441,180.16</u>

INVESTMENTS IN AND ADVANCES TO SUBSIDIARY COMPANIES AND BRANCHES:

	<u>Investments</u>	<u>Open accounts and notes</u>	<u>Together</u>	
<u>Stanford Motor Car Company</u>				
of New York:				
120 shares of \$100.00				
each	\$1,272,000.00	\$ 461,601.01	\$1,733,601.01	
<u>Stanford Motor Car Company</u>				
of Chicago:				
600 shares of \$100.00				
each	172,137.80	669,874.85	842,012.65	
<u>Stanford Motor Car Company</u>				
of Philadelphia:				
120 shares of \$100.00				
each	12,000.00	1,526,874.15	1,538,874.15	
<u>Stanford Motor Car Company -</u>				
Buffalo branch:				
Current account		333,744.19	333,744.19	
Surplus account		515,309.16	515,309.16	
<u>Stanford Motor Car Company -</u>				
Detroit branch		118,216.15	118,216.15	
<u>Stanford Motor Sales Company:</u>				
120 shares of \$100.00 each		1,109,872.79	1,109,872.79	
Reserve against inter-company				
profit in inventories of				
subsidiary companies		660,000.00	660,000.00	
	<u>\$1,456,137.80</u>	<u>\$4,075,492.30</u>	<u>\$5,531,630.10</u>	5,531,630.10

CURRENT ASSETS:

<u>Inventories of raw materials and supplies and finished and</u>	
<u>partly finished parts and carriages and trucks on hand:</u>	
Raw materials, supplies and parts	\$15,346,416.39
Finished carriages and trucks	<u>7,924,006.09</u>
	23,270,422.48
Accounts receivable, less reserve	5,294,408.78
Notes receivable	115,773.00
Miscellaneous investments	201,399.30
Liberty bonds and U.S. Treasury certificates	5,087,427.60
Cash in banks and on hand	<u>2,517,235.04</u>
	36,486,666.20

DEFERRED CHARGES TO FUTURE OPERATIONS:

Prepaid interest, insurance, taxes, etc.	256,561.89
	<u>\$56,718,038.35</u>

Exhibit I

CAR COMPANYSEPTEMBER 30, 1928LIABILITIESCAPITAL STOCK:Authorized:

7% cumulative preferred stock -	
100,000 shares of \$100.00 each	\$10,000,000.00
Common stock -	
150,000 shares of \$100.00 each	15,000,000.00
	<u>\$25,000,000.00</u>

Issued and outstanding:

Preferred stock - 98,000 shares	\$ 9,600,000.00
Common stock - 141,761 "	14,178,100.00
	<u>\$23,778,100.00</u>

Less - Capital stock held for employees
under contract

187,800.00 \$23,588,300.00

FIVE PER CENT GOLD NOTES, due November 15,
1929:

Authorized issue	\$9,000,000.00	
Less - Not sold	<u>3,000,000.00</u>	6,000,000.00

PURCHASE MONEY OBLIGATIONS

652,644.31

CURRENT LIABILITIES:

Note payable to bank (secured by deposit
of \$3,000,000.00 of gold notes of the
company)

\$1,272,518.40

Accounts payable and accrued payrolls

4,369,352.29

Unaudited vouchers

1,666,520.27

Buffalo Civic fund

15,300.55

Deposits by dealers

288,200.40

Deposits by apprentices

5,305.20

Accrued royalties and interest

268,719.02

Reserve for Federal income tax

1,607,853.74

Reserve for other taxes

167,056.06

Reserve for workmen's compensation

27,973.69

Reserve for additional discount - dealers

419,521.82

10,108,321.44

SURPLUS:

Balance at October 1, 1927

\$ 6,908,971.12

Add - Net profits for the year ending

10,984,259.48

September 30, 1928

\$17,891,230.60

Deduct - Dividends paid and declared:

On preferred stock, 7% \$872,000.00

On common stock, 6% 852,458.00

1,524,458.00

16,366,772.60

\$56,716,038.35

STANFORD MOTORSTATEMENT OF
FOR THE YEAR ENDINGGross profit:

<u>Particulars</u>	<u>Net sales (i. e. less discounts and allowances) including shipments to branches</u>		<u>Deduct Cost of sales</u>		<u>Gross profit</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
<u>Main division:</u>						
Carriages and equipment (10,374)	\$19,261,925.75	100.00	\$16,280,025.95	84.52	\$ 2,981,899.80	15.48
Average per carriage	\$1,856.75		\$1,569.31		\$287.44	
<u>Truck division:</u>						
Chassis and equipment (16,096)	\$31,933,255.67	100.00	\$23,827,619.19	74.62	\$ 8,105,636.48	25.38
Average per truck	\$1,989.92		\$1,480.34		\$509.58	
Bodies	139,889.47	100.00	128,365.63	91.76	11,523.84	8.24
Together	\$32,073,145.14	100.00	\$23,955,984.82	74.70	\$ 8,117,160.32	25.30
<u>Service division:</u>						
Service parts	\$ 9,003,398.59	100.00	\$ 7,163,735.45	79.57	\$ 1,839,663.14	20.43
Service repairs	252,365.68	100.00	207,794.86	82.34	44,570.82	17.66
Together	\$ 9,255,764.27	100.00	\$ 7,371,530.31	79.64	\$ 1,884,233.96	20.36
Totals	\$60,590,835.16	100.00	\$47,607,541.08	78.57	\$12,983,294.08	21.43

(Exhibit II-a)

Profit on special type engines manufactured under special contracts

1,974,000.00

Gross profit

\$14,957,294.08

Other income:

Discount on purchases	\$437,086.82	
Income from investments	30,388.50	
Interest received	126,528.54	
Rentals received	55,295.17	
Royalties received	43,191.04	
Patent revenue	52,469.07	
Profit on sale of material	75,878.96	
Miscellaneous	13,070.36	833,908.46
Total profits and income (forward)		\$15,791,202.54

Exhibit II

C A R C O M P A N YPROFITS AND INCOMESEPTEMBER 30, 1928

Total profits and income (forward)	\$15,791,202.54
------------------------------------	-----------------

Deduct - Selling, general and administrative expenses, etc.:

General and administrative (Exhibit II-b)	\$397,824.04	
Selling { " II-b)	345,375.32	
Advertising { " II-b)	393,299.65	
Technical service { " II-b)	190,252.67	
Engineering expenses - development and experimental	958,042.37	
Special compensation to officers and employees	106,266.48	
Cash discount allowed dealers	84,980.05	
Interest on dealers' deposits	17,280.00	
Interest on acceptances	12,070.52	
Dues - Automobile Chamber of Commerce	11,997.76	
Reserve for bad and doubtful accounts	30,000.00	
Provision for additional vehicle tax and miscellaneous revenue taxes	77,543.47	
Miscellaneous expenses "	<u>6,581.21</u>	2,631,513.54

Balance - net profit from operations	<u>\$13,159,689.00</u>
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Deduct - Interest on indebtedness:

On debentures	\$300,000.00	
On bank loans	<u>427,833.36</u>	727,833.36

Net factory profit for the year	<u>\$12,431,855.64</u>
---------------------------------	------------------------

Add - Profits of Buffalo branch:

Net profit for the year	\$ 49,534.85	
Adjustment of previous year's profits	<u>56,868.99</u>	106,403.84

Net profits and income for the year	<u>\$12,538,259.48</u>
-------------------------------------	------------------------

<u>Deduct</u> - Federal income tax	1,554,000.00
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Balance, transferred to surplus account (Exhibit I)	<u><u>\$10,984,259.48</u></u>
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Exhibit II-a

STANFORD MOTOR CAR COMPANYSTATEMENT OF COST OF SALESFOR THE YEAR ENDING SEPTEMBER 30, 1928

Purchases	\$28,968,883.20	
Inbound freight	510,567.99	\$29,478,851.19
Productive labor		5,652,483.15
Factory overhead:		
Non-productive labor	\$ 3,680,166.61	
Superintendence	1,529,318.18	
Factory supplies	843,416.10	
Fuel	648,596.11	
Power	159,905.71	
Tools, dies and patterns	3,629,403.31	
Repairs and maintenance	972,380.40	
Depreciation	759,593.57	
Amortization of property additions	355,158.37	
Maintenance service and traffic vehicles	83,358.29	
Traffic department expense	85,632.65	
Purchasing and stock expense	167,039.40	
Timekeeping expense	23,760.00	
Taxes	334,734.13	
Insurance	57,087.10	
Factory administration	192,960.00	
Printing and stationery	115,060.66	
Traveling expense, etc.	31,791.53	
Legal expense	24,788.18	
Telephone and telegraph	27,964.52	
Freight expense	9,649.39	
Experimental expense	9,214.44	
Postage	4,174.20	
Miscellaneous department expenses	345,937.92	14,091,090.77
Total charges		49,222,405.11
Deduct:		
Miscellaneous sales of material	\$ 22,138.94	
Proportion charged to special type engine division	2,198,638.06	
Internal orders applicable to property and expense accounts	7,785,743.68	10,006,520.68
Net charges		\$39,215,884.43
Add or deduct - Factory inventories:		
At beginning of year		22,267,920.32
At end of year		13,876,263.67
Balance, being cost of sales, carried to statement of profits and income (Exhibit II)		\$47,607,541.08

Exhibit II-b

STANFORD MOTOR CAR COMPANYSTATEMENT OF SELLING, GENERAL AND ADMINISTRATIVE EXPENSESFOR THE YEAR ENDING SEPTEMBER 30 1922

<u>P a r t i c u l a r s</u>	<u>Administrative and General</u>	<u>Selling</u>	<u>Advertising</u>	<u>Technical service</u>	<u>Total</u>
Salaries, officers, department heads and clerks	\$295,409.77	\$174,730.38	\$ 57,515.59	\$ 63,147.19	\$ 590,802.93
Stationery and office supplies	19,448.86	12,374.88	3,773.36	10,734.36	43,337.46
Postage	4,387.31	6,702.53	2,115.96	1,300.20	14,506.00
Telephone and telegraph	4,112.65	19,799.94	2,637.74	1,847.69	28,398.02
Traveling expense	8,586.61	32,778.52	3,178.38	20,062.96	64,606.47
Legal expense	12,049.22	72.00			12,121.22
Contributions	288.54		35,375.24		35,663.78
Membership fees			6,657.73		6,657.73
Educational work, recreation, etc.	18,192.43	6,863.71	1,234.42	5,930.80	32,221.36
Instruction books, price lists, etc.		2,336.99		24,301.86	26,638.85
Advertising in periodicals, etc.			162,075.77		162,075.77
Catalogs, advertising matter, etc.			63,567.90		63,567.90
Drawings and photographs purchased	9.72	78.00	4,493.35		4,581.07
Photographic supplies			7,901.58		7,901.58
Engravings and "electros"			11,176.56		11,176.56
"Stanford" Publication	4,955.65		30,710.11		35,665.76
Conventions, exhibitions, etc.		7,696.46	8,212.08		15,908.54
Repairs to building fixtures			49.39		49.39
Maintenance of vehicles	4,356.20				4,356.20
Extraordinary expenses	3,298.01	6,632.13			9,930.14
Miscellaneous department expenses	64,738.51	60,817.69	775.16	283.56	126,314.92
Other expenses	27,378.53	11,275.02	4,867.02	58,023.85	101,543.92
	941.75	3,217.07	4,783.07	60.81	15,002.70
Together	\$466,213.96	\$345,375.32	\$393,399.65	\$190,252.67	\$1,397,141.60
Less - Proportion charged against special type engine production	70,389.92				70,389.92
Balance carried to statement of profits and income (Exhibit II)	\$397,924.04	\$345,375.32	\$393,399.65	\$190,252.67	\$1,326,751.69

PROBLEM 85

GRANT, SHERIDAN & Co.

Report Submitted as Result of Annual Audit

Messrs. Grant, Sheridan & Co., Certified Public Accountants located at 111 West Monroe Street, Chicago, rendered all kinds of public accounting services, but the most extensive phase of its practice related to work following the fiscal closing dates of clients, namely, audits, income tax returns, and so forth. The firm maintained branch offices in five or six other leading cities, with a total staff of several hundred accountants.

Among the clients of the firm was The Anderson Mfg. Company of Chicago, manufacturer of various types of castings and of miscellaneous steel products. The company's annual sales approximated \$7,000,000, and it had total assets of some three and one-half million dollars. For various reasons, the company had decided not to have its accounts audited for the fiscal year ended December 31, 1927, but otherwise its accounts had been audited annually since the inception of the company. The audit for the fiscal year ended December 31, 1928 was begun shortly after the middle of January, 1929, and was completed on February 20; the report was then prepared and typed, and submitted to the client under date of March 1, 1929. The report, both text and appended exhibits, is reproduced on pages 401-423 following.

Study the report, both text and exhibits; observe the several divisions of the report, and the location and relation of each to the whole. Note carefully the materials included in the report; do any of them seem superfluous, that is, are there any parts of the report which you would omit? Defend your position. Or, do you feel that you lack essential information concerning the business and the results of the year's operations? If so, what would you add to the report? Discuss. Is the form of the report pleasing? If not, how would you alter it? Discuss.¹

¹ See Jackson, "Audit Certificates and Reports," *The Accounting Review*, Vol. I (September, 1926), pp. 45-63; Staub, "How to Write a Report," *The Journal of Accountancy*, Vol. XXX (September, 1920), pp. 169-173; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 406-431.

The Anderson Mfg. Company

Auditors' Report
for the Year Ended December 31, 1928

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* * * * *

GRANT, SHERIDAN & CO.

Certified Public Accountants

111 West Monroe Street,

Chicago

March 1, 1929.

The Anderson Mfg. Company,
Chicago, Illinois.

Dear Sirs:

In accordance with your instructions, we have audited the accounts of The Anderson Mfg. Company for the year ended December 31, 1928 and now submit our report thereon, together with the financial statements listed in the index.

Before proceeding with the detailed discussion of the results from operations and the comments on the balance sheet, it will be of interest to summarize briefly the outstanding features of the company's operations and the changes in financial condition during 1928:

- (1) Sales for 1928 amounted to \$6,957,263.58 as compared with \$6,500,357.30 in 1927, an increase of \$456,906.28 - 7%. In number of castings sold, 1928 shows an increase over the previous year of 9,150,796 - 41%.
- (2) Gross profits after royalties amounted to \$1,744,038.28 - 25.07% of sales, as compared with \$1,465,337.04 - 22.54% of sales in 1927.
- (3) Operations for 1928 resulted in a final net profit of \$936,645.66 - 13.46% of sales, which was 58.98% of the average net worth for 1928.
- (4) The elements of profit and loss expressed in per cent of net sales for 1927 and 1928 are shown below:

-2-

Particulars	Per Cent of Net Sales	
	1927	1928
Cost of Sales	63.85	57.54
Royalties (Net)	13.61	17.39
Miscellaneous Income	1.50	2.26
Selling and General Expenses	11.96	12.63
Federal Taxes	2.12	1.24
Final Net Profit	9.96	13.46
Total	100.00	100.00

- (5) Although the Working Capital increased from \$1,388,273.56 at December 31, 1927 to \$1,686,628.72 at December 31, 1928, the ratio of current assets to current liabilities decreased from 2.67 to 1 to 2.22 to 1. The increase in working capital is the result of the following changes:

Particulars	Amount of Increase or Decrease	
Current Assets -		
Cash	\$ 5,803.66	
Securities	325,616.50	
Receivables	529,262.20	
Due from Affiliated Companies	139,861.28	
Inventories	140,394.20	\$849,607.96
Current Liabilities -		
Accounts Payable	\$299,952.54	
Due to Affiliated Companies	189,998.02	
Accrued Federal Taxes	51,920.60	
Bonus due Officers and Employees	113,222.84	551,252.80
Increase in Working Capital		\$298,355.16

- (6) Net Worth increased from \$1,269,685.56 to \$1,906,331.22, an increase of \$636,645.66 represented by:

Surplus Net Profits	\$936,645.66
Less - Cash Dividends	300,000.00
As above	\$636,645.66

The book value of the stock per share increased during the year from \$126.97 to \$190.63 or \$63.66.

-5-

- (7) During 1928 the company invested \$338,308 in stock of the B Company, the controlling interest in which is owned by stockholders of the Anderson Mfg. Company.

RESULTS FROM OPERATIONS

The operations for 1928 resulted in a net profit of \$936,645.66, the largest amount of profit obtained in any year since the inception of the company. The profit and loss account for 1926, 1927, and 1928 is presented in summary form below in order to provide a general comparison of the operations of 1928 with those of the prior two years.

Particulars	1 9 2 6	*1 9 2 7	1 9 2 8
Number of castings sold	30,600,630	22,307,506	31,458,302
Sales	\$9,398,656.48	\$6,500,357.30	\$6,957,263.58
Cost of Sales	6,514,823.68	4,149,991.92	4,003,238.80
Gross Profit % of Sales	\$2,883,832.80 30.68	\$2,350,365.38 36.15	\$2,954,024.78 42.46
Royalties Earned	187,798.88	152,520.34	103,059.28
Royalties Paid and Accrued % of Sales	\$3,071,631.68 1,307,841.26 13.91	\$2,502,885.72 1,037,548.68 15.96	\$3,057,084.06 1,313,045.80 18.87
Gross Profits after Royalties	\$1,783,790.42	\$1,465,337.04	\$1,744,038.26
Miscellaneous Income	136,477.44	97,663.30	157,250.04
Total Profits and Income	\$1,900,267.86	\$1,563,000.34	\$1,901,288.30
Selling and General Expenses % of Sales	748,414.78 7.96	777,430.72 11.96	878,642.64 12.63
Net Profits before Special Charges	\$1,151,853.08	\$ 785,569.62	\$1,022,645.66
Special Charges - Inventory Losses, etc.	86,494.00		
Federal Income and Profits Taxes	458,000.00	137,920.60	86,000.00
	\$ 544,494.00	\$ 137,920.60	\$ 86,000.00
Surplus Net Profits % of Sales	\$ 607,359.08 6.40	\$ 647,649.02 9.96	\$ 936,645.66 13.46

* We have not audited the accounts for the year 1927, and the results for that year are presented per books, except for minor adjustments.

-4-

The principal features of the operations for 1928 are noted below:

- (1) Sales (\$6,957,263.58) increased \$456,906.28 over 1927, but in comparison with 1926 decreased \$2,441,392.90. The number of castings sold in 1926 and in 1928 is approximately the same.
- (2) Gross profits after royalties amounted to \$1,744,038.26 in 1928, as compared with \$1,763,790.42 in 1926 and \$1,465,337.04 in 1927. In ratio to sales, however, there has been a consistent increase from 18.77% in 1926 to 25.07% in 1928.
- (3) Selling and General Expenses increased from \$748,414.78 - 7.96% of sales in 1926 to \$777,430.72 - 11.96% of sales in 1927 and \$878,642.64 - 12.63% of sales in 1928.
- (4) Final net profits expressed in per cent of sales have increased from 6.40% in 1926 to 13.46% in 1928. The factors contributing to the increase of profits in 1928 over 1927 may be summarized as follows:

<u>Particulars</u>	<u>1928 over 1927</u>
Sales - Increase	\$456,906.28
Cost of Sales - Decrease	146,753.12
Royalties - Net - Increase	324,958.18
Miscellaneous Income - Increase	59,586.74
Selling and General Expenses - Increase	101,211.92
Federal Taxes - Decrease	51,920.60
Increase in Profits	\$288,996.64

SALES:

The trend of the sales of heavy castings for the past three years is shown in the following summary of sales value, castings sold and average price per casting with respect to the principal types of castings sold:

-5-

Particulars	S A L E S V A L U E			Increase or Decrease
	1 9 2 6	1 9 2 7	1 9 2 8	1928 over 1927
#1	\$7,218,796.58	\$5,185,547.96	\$3,407,454.64	\$221,908.68
#2	860,441.04	1,697,265.32	2,569,002.44	871,737.12
#3	1,125,525.40	1,291,193.68	570,788.24	720,405.44
Others	31,769.46	201,223.66	282,542.02	81,318.56
Total	\$9,234,532.28	\$6,375,230.62	\$6,829,787.34	\$454,556.72

Number of Castings Sold				
#1	24,316,208	11,182,710	15,065,514	3,882,804
#2	3,106,190	7,067,730	12,877,708	5,809,978
#3	3,050,906	3,560,688	2,010,120	1,350,568
Others	127,326	696,378	1,504,960	808,582
Total Castings	30,600,630	22,307,506	31,458,302	9,150,796

Average Price - Cents per Casting				
#1	29.69¢	28.48¢	22.61¢	5.87¢
#2	27.70	24.02	19.94	4.03
#3	36.82	38.42	28.59	10.03
All Castings	30.18	28.57	21.71	6.86

The marked decreases in sales price of the different types of castings during the three years is clearly indicated in the summary of the average selling prices per casting. The decline in prices in 1928 as compared with 1927 is reflected in the disproportionate increase in sales value as compared with the increase in castings sold. An increase in number of castings sold of 41% was accompanied by an increase in sales value of but 7%.

The increase in sales is analyzed as to the price and quantity factors in the following tabulation:

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	#1	#2	#3	Total
Quantity-Increase arising from increase in castings sold at 1927 Sale Price	3,882,804 @ 28.48¢ \$1,105,822.58	5,809,978 @ 24.02¢ \$1,395,556.70	1,350,568 @ 38.42¢ \$518,888.22	9,150,796 @ 28.57¢ \$2,615,297.50
Price-Decrease arising from lower selling prices	15,065,514 @ 5.87¢ 883,915.90	12,877,708 @ 4.03¢ 523,819.58	2,010,120 @ 10.03¢ 201,517.22	31,458,302 @ 6.86¢ 2,160,740.78
Increase or Decrease in Sales	\$ 221,906.68	\$ 871,737.12	\$720,405.44	\$ 454,556.72

As shown above, the castings sold in 1928 at the selling prices obtaining in 1927 would have resulted in an increase in sales value of \$2,615,297.50; the decrease in sales value, due to price decline, was \$2,160,740.78; the two factors resulted in a net increase in sales value of \$454,556.72.

During 1928, production and sales of #4 castings was begun; 1,403,960 castings of this type were sold during 1928. These castings sold for the lowest average price of any in 1928, the price at the close of the year being 21¢ each as compared with 25¢ for #1 and #2.

COST OF SALES:

The decrease in selling prices has been accompanied by a corresponding decrease in the cost of castings as shown in the following summary:

Type	Average Cost per Casting Sold		
	1926	1927	1928
#1	20.81¢	18.62¢	13.34¢
#2	15.29	12.87	10.32
#3	27.56	26.49	19.30
All Castings	20.90	18.17	12.42

This decline in costs has more than offset the decline in selling prices, resulting in an increase in the margin of gross profit from 30.73% of

-7-

sales in 1926 and 36.42% in 1927 to 42.78% in 1928. Although sales increased \$454,556.72 in 1928 over 1927, cost of sales decreased \$145,502.80. The relative importance of the price and quantity factors in the decrease in costs of sales is shown in the summary below:

	#1	#2	#3	All Castings
Quantity-Increase arising from increase in castings sold	3,882,804 @18.62¢ \$722,978.10	5,809,978 @12.87¢ \$747,744.16	1,350,568 @26.49¢ \$357,765.46	9,150,796 @18.17¢ \$1,663,549.56
Price-Decrease arising from lower cost of castings sold	15,065,314 @ 5.28¢ \$793,981.44	12,877,708 @ 2.50¢ \$323,158.88	2,010,120 @ 7.19¢ \$144,434.78	31,458,302 @ 5.75¢ \$1,808,852.36
Increase or Decrease in Cost of Sales	\$ 71,003.34	\$424,585.28	\$502,200.22	\$ 145,502.80

GROSS PROFIT

The following summary sets forth the gross profit and ratio to sales for each type of casting for the years 1926, 1927, and 1928:

Particulars	1926	1927	1928	Increase or Decrease 1928 over 1927
#1	\$2,157,720.02	\$1,103,317.52	\$1,396,227.54	\$292,910.02
% of Sales	29.89	34.63	40.97	
#2	385,348.00	787,075.54	1,254,227.18	447,151.84
% of Sales	44.78	46.37	48.04	
#3	282,681.48	400,913.18	182,707.98	218,205.20
% of Sales	25.16	31.04	32.01	
All Castings	2,837,948.56	2,321,873.82	2,921,953.34	600,059.52
% of Sales	30.73	36.42	42.78	

Although the ratio of gross profits to sales has increased, the gross profit per casting has decreased. The above statement of gross profits may be expressed in cents per casting sold as follows:

	1926	1927	1928	Decrease 1928 over 1927
#1	8.88¢	9.86¢	9.27¢	.59¢
#2	12.41	11.15	9.58	1.57
#3	9.28	11.93	9.09	2.84
All Castings	9.28	10.40	9.29	1.11

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Inasmuch as the gross profits per casting in 1928 were less than in 1927 it follows that the increased profit of \$600,059.52 is due entirely to the increase in number of castings sold, as shown below:

	#1	#2	#3	All Castings
Gross Profit -				
Increase due to increase in castings sold	\$382,844.48	\$647,812.54	\$161,122.76	\$951,947.94
Decrease due to decreased profit per casting	89,934.46	200,660.70	57,082.44	351,888.42
Net Increase	\$292,910.02	\$447,151.84	\$218,205.20	\$600,059.52

ROYALTIES EARNED:

Royalties were earned in 1928 as follows:

The Anderson Mfg. Company, Ltd. (Canada)	\$ 96,026.68
The Anderson Mfg. Company (England)	1,911.30
W. O. Olson	5.30
F. Company	5,116.00
T o t a l	\$103,059.28

The Canadian Company pays one half of its gross profits to The Anderson Mfg. Company as royalty. In addition it pays a royalty of 1/2¢ each on #1 Castings sold which amounted to \$80.00 in 1928. Royalties received from the English Company are based on number of castings sold, the payment being 1/2¢ each up to 1,200,000 and 1¢ each for all sales over that amount. The F - Company pays a royalty of 1/2¢ each on Sampson Plates, the amounts received from this source in 1928 being \$5,116.00.

ROYALTIES PAID:

Royalties paid in 1928 amounted to \$1,313,045.80 as compared with \$1,037,548.68 for the previous year. In ratio to gross profits plus royalties earned, these payments were 43.58% in 1926, 41.45% in 1927, and 42.95% in 1928.

SELLING AND GENERAL EXPENSES:

The principal items of these expenses for 1928 are as summarized below from Exhibit III:

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Particulars	Amount	% of Total	% of Sales
Officers Salaries and Bonus	\$273,935.22	31.17	3.94
Other Salaries	209,990.32	23.90	3.02
Traveling Expenses	140,960.04	16.04	2.05
Commissions	81,670.18	9.30	1.17
All Other Expenses	172,086.88	19.89	2.47
Total	<u>\$878,642.64</u>	<u>100.00</u>	<u>12.63</u>

It will be noted that the compensation of officers amounted to 31.17% of the total expenses, and were 3.94% of sales. In comparison with 1927 the officers' compensation increased by approximately the amount of the 1928 bonus, \$108,735.54. The Total increase of selling and general expenses in 1928 over 1927 was \$101,211.92 - 13%.

UNFILLED ORDERS AND PURCHASE COMMITMENTS:

At the close of the year the company had unfilled sales orders for 10,721,088 castings and blanket contracts for 6,002,220 castings on which delivery had not been specified. The unfilled orders were as follows:

Type	Amount
#1	5,377,040
#2	3,726,540
#3	672,108
#4	111,800
#5	833,600
T o t a l	<u>10,721,088</u>

To cover these requirements, purchase commitments have been placed

as below:

Type	Unshipped Purchases	Contracts- Delivery not Specified	T o t a l
#1	1,854,040	3,947,886	5,801,926
#2	1,882,150	459,534	2,341,684
#3	672,108	111,252	783,360
#4	95,800	413,980	509,780
#5	833,600	-	833,600
	<u>5,337,698</u>	<u>4,932,652</u>	<u>10,270,350</u>

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CHANGES IN FINANCIAL CONDITION

A comparison of the financial condition of the company at December 31, 1927 and December 31, 1928 is summarized below from Exhibit IV:

Particulars	December 31,		Increase or Decrease
	1927	1928	
Current Assets	\$2,219,608.70	\$3,069,216.66	\$849,607.96
Less - Current Liabilities	831,335.14	1,382,587.94	551,252.80
Working Capital	\$1,388,273.56	\$1,686,628.72	\$298,355.16
Ratio Current Assets to Current Liabilities	2.67 to 1	2.22 to 1	
Investment in Affiliated Companies	156,942.12	501,614.92	344,672.80
Fixed Assets	124,469.88	118,087.58	6,382.30
Total	\$1,669,685.56	\$2,306,331.22	\$636,645.66
Less - Provision for Contingent Federal Taxes	400,000.00	400,000.00	-
Net Worth	\$1,269,685.56	\$1,906,331.22	\$636,645.66
Represented by -			
Capital Stock	\$1,000,000.00	\$1,000,000.00	\$ -
Surplus	269,685.56	906,331.22	636,645.66
(as above)	\$1,269,685.56	\$1,906,331.22	\$636,645.66
Book Value of Stock Per Share	\$126.97	\$190.63	\$63.66

This tabulation shows that the working capital increased during 1928 from \$1,388,273.56 at the beginning of the year to \$1,686,628.72 at December 31. Although working capital increased, the current ratio decreased from 2.67 to 1 to 2.22 to 1. Current Liabilities increased \$551,252.80 during the year; in order to have maintained the same current ratio as existed at the beginning of the year, the current assets should have increased \$1,471,844.98 (2.67 x \$551,252.80). Current Assets increased only \$849,607.96, which resulted in the decreased ratio shown.

The funds provided from the profits for 1928 of \$967,860.32 (net profits of \$936,645.66 plus provision for depreciation of \$31,214.66 which does not represent a cash expenditure) were disposed of as follows:

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Disposition	Amount
Cash Dividends	\$500,000.00
Investment in affiliated companies	344,672.80
Additions to fixed assets	24,832.36
Increase in working capital as summarized below	296,555.16
Total (as above)	<u>\$967,860.32</u>

SUMMARY OF WORKING CAPITAL

Particulars	December 31,		Increase or Decrease
	1927	1928	
Current Assets -			
Cash	\$ 216,585.90	\$ 210,782.24	\$ 5,803.66
Securities	515,766.40	841,382.90	325,616.50
Receivables	1,175,231.44	1,704,493.64	529,262.20
Due from Affiliated Companies	247,507.44	107,646.18	139,861.26
Inventories	64,517.52	204,911.72	140,394.20
T o t a l	<u>\$2,219,608.70</u>	<u>\$3,069,216.66</u>	<u>\$849,607.96</u>
Current Liabilities -			
Accounts Payable	\$ 689,569.50	\$ 989,387.08	\$299,797.58
Due to Affiliated Companies	-	189,998.02	189,998.02
Accruals	141,765.64	203,222.84	61,457.20
T o t a l	<u>\$ 831,335.14</u>	<u>\$1,382,587.94</u>	<u>\$551,252.80</u>
Working Capital (as above)	<u>\$1,388,273.56</u>	<u>\$1,686,628.72</u>	<u>\$298,355.16</u>

It will be of interest to analyze the working capital by showing the percent of the various component items to total current assets as below:

Particulars	December 31st,	
	1927	1928
Cash	9.76%	6.87%
Securities	23.25	27.41
Receivables	52.94	55.53
Due from Affiliated Companies	11.15	5.51
Inventories	2.92	6.68
T o t a l	<u>100.00%</u>	<u>100.00%</u>
Current Liabilities	37.45	45.05
Working Capital	<u>62.55%</u>	<u>54.95%</u>

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COMMENTS ON BALANCE SHEETCURRENT ASSETS - \$3,069,216.66:

Cash in banks at December 31, 1928 was satisfactorily reconciled with certificates obtained from the depositories, and the Chicago Office petty cash fund was examined. Funds on hand at New York and St. Louis amounting to \$1,900.00 were not verified.

U. S. Government Bonds were counted by our representative. The amounts owned were as follows:

Particulars	Par	Cost
1st 3-1/2% Liberty Bonds	\$160,000.00	\$141,562.80
4th 4-1/4% Liberty Bonds	190,000.00	169,884.00
4-3/4% Certificates of Indebtedness	30,000.00	30,487.50

Corporation and Municipal Bonds were presented for our inspection.

Customers' Accounts amounting to \$1,685,697.08 were due from various companies, the largest balances being as follows:

Company	Amount	%
Brown Company	\$ 198,732.40	11.79%
Smith Company	100,800.00	5.98
Roberts Company	81,782.52	4.85
Chicago Corporation	300,272.00	17.81
Western Morot Company	94,220.42	5.59
Southern Tractor Company	95,100.00	5.52
All other (69)	816,789.94	48.46
T o t a l	\$1,685,697.08	100.00%

The accounts are classified as to age in the following summary:

Month Billed	Amount
December	\$ 906,523.88
November	391,661.58
October	161,510.02
September	123,542.14
Older	102,659.46
	\$1,685,697.08

In our opinion the above accounts are good and collectible.

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The B - Company Note was paid January 9, 1929. The Anderson Mfg. Company Ltd. Canada Account includes a note for \$40,800.00 due February 21, 1929 for special services.

Inventories of heavy castings, steel and parts on hand at foundries priced at cost, amounted to \$204,911.72. Of this amount \$107,337.90 represents steel purchased for the B - Company which is billed to them as used. The management has certified to the correctness of the inventory value, and we are satisfied that the prices used are lower than market. No physical verification was made of the quantities shown in the inventories.

INVESTMENTS IN AFFILIATED COMPANIES - \$501,614.92:

In accordance with instructions, we have not audited the books of affiliated companies; those investments are carried at cost in the balance sheet.

The company has acquired capital stock of the B - Company as follows:

Preferred Stock 4,376 shares	
par value \$100.00 each	\$437,600.00
Common Stock 708 shares	
of no par value	708.00

The B - Company was organized in 1927 by stockholders of the Anderson Mfg. Company to acquire and operate the forge plant of the C - Company, located at Chicago, Illinois. Equipment for making #2 Castings was installed, and during 1928 more than 3,600,000 were shipped. In addition the plant is doing a general forging business. We were furnished with a statement of the company's financial position at December 31, 1928 which is summarized below:

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Current Assets	\$ 737,810.32
<u>Less - Current Liabilities</u>	<u>689,448.90</u>
Working Capital	\$ 48,361.42
Add - Plant, Equipment, etc.	<u>1,232,555.18</u>
Net Worth	<u>\$1,280,916.60</u>
Represented by -	
Preferred Stock 6,000 shares	\$ 600,000.00
Common Stock 17,000 shares	17,040.00
Capital Surplus	1,032,518.94
Operating Loss for 1928	<u>368,642.34</u>
(As above)	<u>\$1,280,916.60</u>

A controlling interest in the F. Company represented by 300 shares of 400 outstanding, is carried on the books at cost - \$20,000.00.

Advances to the Anderson Mfg. Company (England) Ltd. amounted to \$41,806.92 at December 31. These advances were represented by notes maturing in 1929, which were examined by us.

FIXED ASSETS - \$118,087.58:

Fixed assets, stated at depreciated book values, are as follows:

Patents	\$ 93,050.88
Patterns	18,753.60
Furniture and Fixtures	5,672.24
Equipment	610.86
	<u>\$118,087.58</u>

Depreciation is being provided at the rate of 20% per year on the depreciated balance. In our opinion these assets are conservatively valued.

CURRENT LIABILITIES - \$1,382,587.94:

Trade Accounts Payable of \$989,367.08 include royalties due to C. F. Burke of \$40,593.16. Payment of these royalties has been withheld since September 1928, on account of suit against Mr. Burke, the plaintiff in which has advised the Anderson Mfg. Company that he has a claim against certain royalty

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payments. The Anderson Mfg. Company is withholding payment to protect its rights in the matter.

Due to Affiliated Companies - The following amounts were due for purchases in the usual course:

D & E Company	\$ 68,061.62
B Company	<u>121,936.40</u>

Officers' Bonus - The board of directors provided during 1928 that a bonus be paid the officers based on earnings after taxes - the amount so distributed to be 20% of the earnings over \$500,000. Based on the earnings per books, the bonus amounted to \$108,735.54.

Federal Taxes - The accrued federal taxes have been computed after deducting from the earnings per books \$72,000 as depreciation on contract values, which has not been passed on by the Treasury Department.

CONTINGENT FEDERAL TAXES - \$400,000.00:

The company is subject to additional federal tax assessments on the final review of its returns by the Treasury Department. In the event that the company's claim is disallowed, a considerable additional tax will be assessed, subject possibly to the relief provisions of the various Revenue Acts. To cover the contingent liability, we have set up a reserve of \$400,000. The amortization of contract values for 1928 results in a contingent liability of approximately \$9,000.

NET WORTH - \$1,906,331.22:

The Capital Stock outstanding is represented by 10,000 shares of a par value of \$100 each, which was verified by an examination of the stock certificate books.

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Changes in the Surplus account during 1928 are as shown below:

Balance per books, December 31, 1927	\$ 643,814.04
Less - Audit Adjustments	374,128.48
Adjusted Balance	\$ 269,685.56
Add - Surplus Net Profits for 1928	936,645.66
	<u>\$1,206,331.22</u>
Less - Cash Dividends Paid	300,000.00
Balance December 31, 1928	<u><u>\$ 906,331.22</u></u>

The audit adjustments are as follows:

Charges -		
To reserve for contingent federal taxes	\$ 400,000.00	
1927 royalties taken up in 1928	1,955.18	
1927 taxes taken up in 1928	<u>3,845.04</u>	\$405,800.22
Credits -		
Interest earned in 1927 taken up in 1928	\$ 8,971.16	
Royalties earned in 1927 taken up in 1928	15,527.46	
To cancel Commissions on 1926-27 orders	4,030.72	
To cancel Replacement charge of 1925	<u>3,142.40</u>	\$1,671.74
(as above)		<u><u>\$374,128.48</u></u>

G E N E R A L

During the course of the audit we inspected a large number of vouchers and other supporting data. We did not, however, make a detailed audit of cash transactions with a view to disclose irregularities, should any exist.

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We wish to acknowledge the courtesies and cooperation extended our representatives during the course of the audit.

Very truly yours,

(Signed) Grant, Sheridan & Co.

Certified Public Accountants.

THE ANDERSONBALANCE SHEETASSETSCURRENT ASSETS:

Cash in Banks and on Hand		\$ 210,782.24
Marketable Securities -		
U. S. Liberty Bonds at Cost		
(Market Value \$348,984.00)	\$ 511,246.80	
U. S. Certificates of		
Indebtedness at Cost		
(Market Value \$30,150.00)	30,487.50	
Corporation and Municipal		
Bonds at Cost		
(Market Value \$511,205.50)	499,648.60	841,532.30
Receivables -		
Customers' Accounts	\$1,685,697.08	
Due from Affiliated Companies		
B. Company Note	54,000.00	
Anderson Mfg. Company Ltd. Canada	70,980.16	
F. Company	2,666.00	
Due from Employees	6,443.76	
Accrued Interest on		
Bonds and Notes	12,552.80	1,812,139.80
Inventories at Cost		
Finished Castings, Steel		
and Parts		204,911.72
Total Current Assets		\$3,069,216.66

INVESTMENTS IN AFFILIATED COMPANIES AT COST:

B. Company -		
Preferred Stock - 4,576 shares		
par value \$100.00 each	\$ 457,600.00	
Common Stock - 708 shares no par value	708.00	
F. Company - 500 shares par value		
\$100.00 each	20,000.00	
G. Company - 16-2/3 shares par value		
\$100.00 each	1,500.00	
Anderson Mfg. Company (England) Ltd. 500 shares		
par value - 1£ each	-	
Anderson Mfg. Company (England) Ltd. - Loans and Advances	41,806.92	501,614.92

FIXED ASSETS: (At Depreciated Book Values)

Patents	\$ 95,050.88	
Patterns	18,755.60	
Furniture and Fixtures	5,672.24	
Equipment	610.88	118,087.59
		<u>\$3,688,919.16</u>

EXHIBIT IMFG. COMPANYDECEMBER 31, 1928LIABILITIES AND NET WORTHCURRENT LIABILITIES:

Accounts Payable -	
Trade Creditors	\$ 989,567.08
Due Affiliated Companies	
D. & E. Company	68,061.62
E. Company	121,936.40
Accruals	
Officers' Bonus	108,735.54
Employees' Bonus	4,487.30
Federal Taxes - 1928	86,000.00
Local Taxes	<u>4,000.00</u>

Total Current Liabilities	\$1,582,587.94
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<u>CONTINGENT LIABILITY FOR ADDITIONAL FEDERAL TAXES</u>	<u>400,000.00</u>
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NET WORTH:

Capital Stock -	
Authorized and Issued 10,000	
shares par value \$100.00 each	\$1,000,000.00

Surplus

Balance December 31, 1927	
per books	\$ 643,814.04
Auditors' Adjustments -	
Contingent Federal Taxes	400,000.00
Other	<u>25,871.52</u>

\$ 269,685.56

<u>Add - Surplus Net Profits</u>	
for 1928 per Exhibit II	<u>936,645.66</u>

\$1,206,331.22

Deduct - Cash Dividends Paid	<u>300,000.00</u>	<u>906,331.22</u>	1,906,331.22
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<u>\$3,688,919.16</u>

THE ANDERSONCOMPARISON OFFOR THE TWO YEARS ENDED

1 9
(per Books)

	Number	Sales	Cost
HEAVY CASTINGS			
#1	11,182,710	\$3,185,547.96	\$2,082,230.44
Per Casting		28.48¢	18.62¢
#2	7,067,730	1,697,265.32	910,189.98
Per Casting		24.02¢	12.87¢
#3	3,360,688	1,291,193.68	890,280.50
Per Casting		38.42¢	26.49¢
#4	-	-	-
Per Casting		-	-
#5	691,578	198,823.66	168,816.06
Per Casting		28.74¢	24.41¢
#6	4,800	2,400.00	1,839.82
T O T A L	22,307,506	\$6,375,230.62	\$4,053,356.80
Per Casting		28.57¢	18.17¢
PARTS, ETC.	-	77,257.26	56,495.60
LIGHT CASTINGS	1,506,838	47,869.42	40,139.52
T o t a l		\$6,500,357.30	\$4,149,991.92

ROYALTIES EARNED

LESS: ROYALTIES PAID AND ACCRUED

Gross Profits after Royalties

ADD: MISCELLANEOUS INCOME:

Special Income - The Anderson Mfg. Company, Ltd. (Canada)	\$ 40,800.00
Rent and Service -	
The D. & E. Company	10,000.00
The B. Company	-
Commissions - The Anderson Mfg. Company, Ltd. (Canada)	10,254.40
Interest and Discount	41,127.74
Foreign Exchange	4,518.84

Total Profits and Income

SELLING AND GENERAL EXPENSES (EXHIBIT III)

Profits before Deducting Federal Income Tax
FEDERAL INCOME AND PROFITS TAXES

Surplus Net Profits

MFG. COMPANYEXHIBIT IIPROFITS AND INCOMEDECEMBER 31, 1927 AND 19282 7
and Unaudited)

1 9 2 8

Gross Profits Before Royalties	% of Sales	Number	Sales	Cost	Gross Profits Before Royalties	% of Sales
\$1,103,317.52	34.63	15,065,514	\$3,407,454.64	\$2,011,227.10	\$1,396,227.54	40.97
9.86¢			22.61¢	13.34¢	9.27¢	
787,075.34	46.37	12,877,708	2,569,002.44	1,334,775.28	1,234,227.18	48.04
11.15¢			19.94¢	10.36¢	9.58¢	
400,913.18	31.04	2,010,120	570,788.24	388,080.26	182,707.98	32.01
11.93¢			28.59¢	19.30¢	9.09¢	
-	-	1,403,960	258,458.60	162,675.82	95,782.78	37.05
-	-		18.41¢	11.58¢	6.83¢	
30,007.60	15.09	101,000	24,085.42	11,097.56	12,987.86	55.92
4.33¢			23.84¢	10.98¢	12.86¢	
560.18	23.34	-	-	-	-	-
\$2,321,873.82	36.42	31,458,502	\$6,829,787.34	\$3,907,854.00	\$2,921,935.54	42.78
10.40¢			21.71¢	12.42¢	9.29¢	
20,761.66	28.87	-	68,747.70	46,434.38	22,313.52	32.45
7,729.90	16.14	2,058,430	58,728.54	48,950.42	9,778.12	16.64
\$2,350,365.38	36.15		\$8,957,263.58	\$4,003,238.80	\$2,954,024.78	42.46
152,520.34	2.35				105,059.28	1.48
\$2,502,885.72	38.50				\$5,057,084.06	43.94
1,037,548.68	15.96				1,313,045.80	18.87
\$1,465,337.04	22.54				\$1,744,038.28	25.07
				\$ 40,800.00		
				10,000.00		
				10,000.00		
				2,610.40		
				52,269.90		
97,663.30	1.50			41,589.74	157,250.04	2.26
\$1,563,000.34	24.04				\$1,901,288.50	27.33
777,430.72	11.96				878,642.64	12.63
\$ 785,569.62	12.08				\$1,022,645.68	14.70
137,920.60	2.12				86,000.00	1.24
\$ 647,649.02	9.96				\$ 936,645.66	15.46

EXHIBIT III

THE ANDERSON MFG. COMPANYCOMPARISON OF SELLING AND GENERAL EXPENSES FOR THE TWOYEARS ENDED DECEMBER 31, 1927 and 1928

<u>Particulars</u>	<u>1927</u>	<u>1928</u>	<u>Increase or Decrease</u>
Officers' Salaries	\$165,200.00	\$165,199.68	\$.32
Officers' Bonus	-	108,735.54	108,735.54
Other Salaries	195,875.52	209,990.32	14,114.80
Traveling Expenses	140,083.90	140,960.04	876.14
Commissions on Sales	46,933.12	81,670.18	34,737.06
Pattern Repairs, Tags and Envelopes, Booklets, etc.	38,727.70	15,295.58	23,432.12
Office Expenses	11,794.14	12,356.88	562.74
Advertising	26,386.34	21,929.50	4,456.84
Rent, Chicago and Branches	19,710.54	19,654.54	56.00
Interest Paid	28,588.96	562.50	28,026.46
Sales Discounts	9,392.28	14,476.68	5,084.40
General Expenses	13,775.22	13,044.46	730.76
Legal and Litigation Expenses	21,899.42	14,105.02	7,794.40
Taxes	6,075.04	6,406.00	330.96
Replacements	10,347.36	13,130.58	2,783.22
Insurance	395.90	1,986.04	1,590.14
Sundry Freight	749.95	1,878.80	1,128.84
Experimental Work	325.00	1,254.32	929.32
Old Material Scrapped	96.78	28.68	125.46
Depreciation -			
Patterns	9,017.68	6,533.88	2,483.80
Patents	24,596.66	23,262.72	1,333.94
Furniture and Fixtures	1,269.20	1,418.06	148.86
Audit and Tax Service	6,190.00	1,670.00	4,520.00
Loss on Equipment Sold	-	3,170.00	3,170.00
Total (Exhibit II)	\$777,430.72	\$878,642.64	\$101,211.92

EXHIBIT IV

THE ANDERSON MFG. COMPANYCOMPARISON OF BALANCE SHEETSAT DECEMBER 31, 1927 and 1928

ASSETS	December 31		Increase or Decrease
	1927	1928	
<u>CURRENT ASSETS:</u>			
Cash in Banks and On Hand	\$ 216,585.90	\$ 210,782.24	\$ 5,803.66
U. S. Government Bonds	311,246.80	341,734.30	30,487.50
Corporation and Municipal Bonds	204,519.60	499,648.60	295,129.00
Receivables -			
Due from Customers	1,164,173.86	1,685,697.08	521,523.22
Due from Affiliated Companies	247,507.44	107,646.16	139,861.28
Other	11,057.58	18,796.56	7,738.98
Inventories	64,517.52	204,911.72	140,394.20
Total Current Assets	\$2,219,608.70	\$3,069,216.66	\$ 849,607.96
<u>INVESTMENT IN AFFILIATED COMPANIES</u>	156,942.12	501,614.92	544,672.80
<u>FIXED ASSETS (Depreciated Value)</u>	124,469.88	118,087.58	6,382.30
	<u>\$2,501,020.70</u>	<u>\$3,688,919.16</u>	<u>\$1,187,898.46</u>
<u>LIABILITIES AND NET WORTH</u>			
<u>CURRENT LIABILITIES:</u>			
Trade Accounts Payable	\$ 689,569.50	\$ 989,367.08	\$ 299,797.58
Due to Affiliated Companies	-	189,998.02	189,998.02
Accrued Local Taxes	3,845.04	4,000.00	154.96
Accrued Federal Taxes	137,920.60	86,000.00	51,920.60
Bonus due Officers and Employees	-	113,222.84	113,222.84
Total Current Liabilities	\$ 831,335.14	\$1,582,587.94	\$ 551,252.80
<u>CONTINGENT LIABILITY FOR ADDITIONAL FEDERAL TAXES</u>	\$ 400,000.00	\$ 400,000.00	\$ -
<u>NET WORTH:</u>			
Capital Stock	\$1,000,000.00	\$1,000,000.00	\$ -
Surplus	269,685.56	906,331.22	636,645.66
	<u>\$1,269,685.56</u>	<u>\$1,906,331.22</u>	<u>\$ 636,645.66</u>
	<u>\$2,501,020.70</u>	<u>\$3,688,919.16</u>	<u>\$1,187,898.46</u>

PROBLEM 86

SLOCUM COLLEGE UNION

Audit of Accounts and Preparation of Report

Slocum College was a small men's college with a total enrolment of about three hundred students; it had a general club, which was open to all students, and which was called the Union. The club owned neither buildings nor fixtures of any kind; it merely provided entertainment in the form of speakers, smokers, dances, etc. For these entertainments space was either rented or loaned by the college. The real purpose of the Union was to serve as a social center for the student body.

In May, 1928, the treasurer of the Union, Lawrence B. Wheeler, requested two seniors whose major work had been in the field of accounting to audit the club's books from the beginning of the academic year, September 1, 1927, to April 30, 1928; the audit could later be brought up to June 15, the close of the academic year, if desired. The results of the audit were to be reported to the president of the club, William C. Maddison.

Accordingly, the two seniors conducted their audit in the following manner: They found that the books consisted of a cash receipts book, a check book for the checking account, and a pass book for the savings account. The only other records were the cancelled checks and the bank statements; the treasurer of the club neither retained invoices nor asked for receipts when making any payments. On the basis of these records the seniors checked both the cash receipts and disbursements to the check book and to the bank statements; a bank reconciliation was made for April 30, 1928. Discrepancies and errors were found, viz.:

(a) The opening balance, September 1, 1927, as shown by the check book was \$2 short of the balance as shown by the bank statement. As this error had occurred during some previous period no attempt was made to locate it.

(b) A receipt of \$64 was entered twice in the cash receipts book, first on September 26 and later on October 8. It had, however, been entered only once in the check book. The auditors were satisfied that the second entry in the cash receipts book was made by mistake.

(c) A receipt of December 11 had been entered both in the cash

receipts book and in the check book as \$12.70 but had been credited by the bank as \$12.75.

(d) Interest on the checking account had been credited by the bank on December 31, 1927 for \$4.80, and on March 31, 1928 for \$4.45. No record of these had been made either in the cash receipts book or in the check book. The treasurer had never made a bank reconciliation, hence had not discovered these.

(e) Interest on the savings account had been credited by the bank on November 15 for \$11.50. An entry of this had been made in the pass book but not in the cash receipts book.

Having completed the audit of the records the auditors prepared their report as follows:

Mr. William C. Maddison,
President, Slocum College Union,
Collegeville, Illinois.

Collegeville, Illinois,
May 14, 1928.

Dear Sir:

In accordance with instructions received from Mr. Lawrence B. Wheeler, Treasurer of the Slocum College Union, we have audited the books of the Union for the eight months ending April 30, 1928. A reconciliation of the check book with the bank statement as of April 30 was prepared, and is enclosed herewith.

The cash disbursements were checked, for amount and indorsement, to the check book and bank statement and were found to be correct. The cash receipts were likewise traced to the check book and bank statement. Several adjustments were necessary in the enclosed Income Statement, as follows:

The opening balance, as of September 1, 1927, as shown by the check book was \$2.00 short of the balance as shown by the bank statement. This is an error which occurred in the previous period, and has been taken up in the enclosed statement.

A receipt of \$64.00 was entered twice in the Cash Receipts Book, on September 26 and on October 8. A receipt of December 11 was entered in the Cash Receipts Book and in the check book as \$12.70, but was credited by the bank as \$12.75. Interest on the checking account was credited by the bank on December 31 for \$4.80 and on March 31 for \$4.45; interest for \$11.50 was credited on the savings account on November 15. These interest credits were not recorded in the Cash Receipts Book nor in the check book.

The Treasurer should make the adjustments noted in this report.

Respectfully submitted,

(Signed).....

(Signed).....

Members of Auditing Class

RECONCILIATION OF CHECK BOOK WITH BANK STATEMENT

Balance, per check book, April 30, 1928		\$538.16
Add: Error in Balance, September 1, 1927	\$ 2.00	
Error in deposit, December 11, 1927	.05	
December interest credited by bank	4.80	
March interest credited by bank	4.45	11.30
Balance, per bank statement, April 30, 1928	\$669.28	
Less: Outstanding check, #353, dated April 30, 1928	119.82	\$549.46

INCOME STATEMENT

Opening Cash Balance, September 1, 1927:		
Checking account	\$ 494.58	
Savings account	511.25	\$1,005.83
Cash Receipts:		
Dues	\$1,512.50	
Insignia	75.15	
Entertainment	513.00	
Interest	20.75	
Miscellaneous	21.50	\$2,142.90
Cash Disbursements:		
Entertainment	\$1,190.69	
Executive Board	47.50	
President's Budget	63.50	
Insignia	202.42	
Special meetings	72.41	1,576.52
Net Income for Period		566.38
Balance, April 30, 1928		\$1,572.21
Represented by:		
Checking account	\$ 549.46	
Savings account	1,022.75	
		\$1,572.21

Before delivering their report the students took it to their instructor for criticism; he also glanced through the working schedules which they had prepared as a result of their verification. One of the first things he observed was that they had neglected to get a certificate from the bank confirming the cash balances to the credit of the Union as of April 30, 1928. Furthermore, inquiry revealed that nothing had been done to determine that all cash received had been properly accounted for; while the system of record-keeping would not permit of complete verification in this regard, it would be comparatively easy to determine the annual dues and this was by far the largest source of income

of the Union. It was also suggested that income from entertainment might be checked in case tickets had been used, and any record could be had of the number of these tickets sold. From the discussion it was brought out that all that had been done was to trace the receipts as entered in the cash receipts book to the bank statements, and that no attempt had been made to account for the cash that should have been received.

The student auditors then secured a letter from the treasurer of the Union instructing the bank to give them a certificate of the cash balances of the Union as of April 30, 1928; the certificate was duly received, and the amounts shown thereby were in agreement with the savings pass book and the bank statement of April 30.

Dues to the Union were \$5 per year, payable \$2.50 at the beginning of each semester. In fact, the \$2.50 was collected by the college at the time of registration, and was deposited in the bank to the credit of the Union; the cash was not handled by the treasurer of the Union. By going to the office of the registrar it was ascertained how many students were enrolled in the college each semester; in this way the auditors were satisfied that the proper amount had been deposited to the credit of the Union each semester.

The receipts from the sale of insignia and from entertainment could not be checked exactly, but from memoranda in the possession of the Union treasurer and the entertainment committee it was possible to determine that the recorded receipts were approximately correct, if not entirely so.

When this additional verification work had been completed, and after considerable discussion between themselves, the auditors rewrote their report as follows:

Collegeville, Illinois,
May 18, 1928.

Mr. William C. Maddison,
President, Slocum College Union,
Collegeville, Illinois.

Dear Sir:

In accordance with instructions received from Mr. Lawrence B. Wheeler, Treasurer of the Slocum College Union, we have audited the records of the Union for the eight-months period ended April 30, 1928;

we now take pleasure in submitting our report thereon, together with the following attached exhibits:

Exhibit I – Statement of Cash Position

Exhibit II – Bank Reconciliation, April 30, 1928

Cash in the Collegeville Trust Company at the close of business April 30, 1928 to the credit of the Slocum College Union was as follows:

Checking account	\$ 549.46
Savings account	<u>1,022.75</u>
Total	<u>\$1,572.21</u>

These amounts were confirmed by certificate from the bank; the additions of \$11.30 shown in the Bank Reconciliation (Exhibit II) should be taken up in the check book and in the Cash Receipts Book.

The cash disbursements, as represented by canceled checks, were traced to the check book and to the bank statements, and were found to be in order. Signatures and indorsements were scrutinized and appeared to be proper. We recommend that in the future the treasurer retain the approved invoices as a record of his authority to make disbursements.

The cash receipts as recorded in the Cash Receipts Book were traced to the check book and to the bank statements. An attempt was also made to account for all cash that should have been received during the period under audit; because of the condition of the records it was not wholly possible to accomplish this. The receipts from dues were compared with the records in the Registrar's office, and we satisfied ourselves that the Union had been properly credited for all dues collected. However, in the case of receipts from the sale of insignia, and from entertainment, the information available was not sufficient to make certain that all cash received was properly deposited; subject to your approval we shall be glad to make suggestions for improving this phase of the Union's method of record-keeping.

The net income for the period under audit, as represented by the excess of receipts over disbursements, is shown by the Statement of Cash Position (Exhibit I) appended to be \$566.38. The income from dues is shown by the books to be \$1,576.50; this includes an item of \$64.00 which had been entered twice in the Cash Receipts Book, once on September 26 and again on October 8. The amount was entered only once in the check book; correction should be made in the Cash Receipts Book. Interest consisted of credits made by the bank, as follows:

Checking account, December 31, 1927	\$ 4.80
Checking account, March 31, 1928	4.45
Savings account, November 15, 1927	<u>11.50</u>
Total	<u>\$20.75</u>

The interest on the savings account has been entered in the pass book, but the interest on the checking account has not been entered in the check book; no interest has been entered in the Cash Receipts Book. The

treasurer should take up the \$9.25 in the check book, and the \$20.75 in the Cash Receipts Book as interest earned and received. We suggest that the check book be regularly reconciled with the monthly bank statement; in this way these small errors would be largely or entirely eliminated.

If there is additional information which we can furnish you, we shall be glad upon request to do so.

Respectfully submitted,

(Signed).....

(Signed).....

Members of Auditing Class

STATEMENT OF CASH POSITION

Exhibit I

Cash balance, September 1, 1927:		
Checking account	\$ 494.58	
Savings account	511.25	\$1,005.83
Receipts:		
Dues	\$1,512.50	
Entertainment	513.00	
Insignia	75.15	
Interest	20.75	
Miscellaneous	21.50	\$2,142.90
Disbursements:		
Entertainment	\$1,190.69	
Insignia	202.42	
Executive Board	47.50	
President's budget	63.50	
Special meetings	72.41	1,576.52
Excess of receipts, representing the net income of the period		566.38
Cash balance, April 30, 1928		<u>\$1,572.21</u>

RECONCILIATION OF CHECKING ACCOUNT

Exhibit II

Balance, per Bank Certificate, April 30, 1928	\$669.28
Less: Outstanding check #353, dated April 30, 1928	119.82
Balance, per check book as adjusted	<u>\$549.46</u>
Balance, per check book	\$538.16
Add:	
Error in balance, September 1, 1927	\$2.00
Error in deposit, December 11, 1927	.05
Interest credited by bank, December 31, 1927	4.80
Interest credited by bank, March 31, 1928	4.45
Balance adjusted, as above	<u>11.30</u>
	<u>\$549.46</u>

Study the above audit procedure, and the report submitted upon the completion of the work; criticize constructively the work as performed. Wherein is the second report an improvement, if

it is, upon the first draft? Are the final exhibits an improvement over the drafts? If so, wherein? If not, why not? The suggestion is made in the final report that the auditors will recommend improvements in the accounting methods if they are requested to do so; what improvements may be suggested? Discuss.

PROBLEM 87

CHARLOTTE MILLS, INCORPORATED—PART XIV

Preparation of Final Statements, Certificate, and Audit Report

Upon the completion of your audit, as set forth in Part XIII of the Problem (pp. 341-344), you return to the office of your firm in the First National Bank Building, release your assistants for other work,¹ and proceed to draw up in final form the balance sheet and profit and loss statement for discussion with your principal.² You also proceed to draft a descriptive certificate to be attached to the above two statements, and then proceed with the preparation of your detailed report on the audit. It had been the policy of your firm in previous years to deliver the certified accounts to the Treasurer of Charlotte Mills, Incorporated as soon as possible after the completion of the audit; the preparation of the report would require several days' time, and it would be delivered to the client at a later date.

Prepare the balance sheet and statement of profit and loss for certification, and the descriptive certificate applicable thereto; be prepared to defend the statements and your certificate when you take them up for discussion with your principal.³

Next proceed to prepare the detailed report on the audit which you will submit to the directors of Charlotte Mills, Incorporated.

¹ It is probable that there will be certain schedules to copy, computations to verify, and so forth, so that it may be desirable to have one assistant continue on the assignment until this work is done; unless there will be considerable work of this kind, however, all assistants may be released. Undoubtedly there will be some "available" assistant about the office who can be given this work to do when it is ready to be done.

² Although you may not entirely approve of the form of balance sheet used at June 30, 1923 (see Part I of the Problem, pp. 80-81) in stating the company's accounts, it is probable that the company prefers that form. The balance sheet is the balance sheet of the client, and any form which discloses the facts sufficiently and fairly is acceptable. See Jackson, *Audit Working Papers*, pp. 40-44.

³ See Himmelblau, *Auditors' Certificates*, pp. 8-55; Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 460-468.

The length of the report, the number and nature of the exhibits to be included, and the points arising on the audit which should be emphasized, are all left to your discretion.⁴

PROBLEM 88

THE NORTH AMERICAN SHIPBUILDING COMPANY

Preparation of Accounts and Audit Report

The North American Shipbuilding Company was situated in Philadelphia; the executive offices of the company were located in the heart of the financial district of the city, while its shipyards were located near the juncture of the Schuylkill and Delaware Rivers. For a number of years the company had had its accounts audited annually by Messrs. Scrooge & Marlowe, 20 South Broad Street, Philadelphia; the fiscal year of the company was from January 1 to December 31.

Messrs. Scrooge & Marlowe conducted each year a limited-test, or balance sheet audit of the company's books and accounts; upon the completion of the audit the accountants prepared and certified the balance sheet and relative income statement of the company—the statements were prepared in reasonable detail, and were accompanied by a long or descriptive certificate. The report each year was addressed to the board of directors of the company, and was intended to set forth the essential information concerning the company's operations and financial condition. The audit was begun each year early in January, and completed in time for the accounts to be presented to the stockholders at their regular meeting early in March; the certified balance sheet was desired as early in February as possible in order that it might be published in leading financial columns.

The audit of the company for the fiscal year ended December 31, 1922 was completed by the tenth of February, 1923; the complete working papers, as prepared by the representatives of Messrs. Scrooge & Marlowe, and setting forth the facts concerning the company's accounts for the fiscal year 1922, are to be

⁴ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 406-431; Jackson, "Audit Certificates and Reports," *The Accounting Review*, Vol. I (September, 1926), pp. 45-63.

found as Appendix A in Jackson's *Audit Working Papers*.¹ The supervising assistant on the assignment has already prepared the final accounts for certification, and has drafted the certificate to be attached to them. The report on the audit, however, remains yet to be prepared.

You are requested to prepare the audit report, including the statements to be appended to the text material, which will be submitted to the board of directors of The North American Shipbuilding Company, and which will be read at the annual meeting of the stockholders of the company. Be sure that your report contains interesting news; you are cautioned against making it too long, and yet all essential information should be included.²

¹ See Jackson, *Audit Working Papers*, Appendix A. Published by American Institute of Accountants Foundation, New York, 1923.

² A decision which purports to become a leading case has just been rendered by the Supreme Court of the state of New York (see *New York Law Journal*, June 14, 1929) in *Ultra Mares v. Touche, et al.* Defendants were public accountants who were employed in February, 1924 by Fred Stern & Company, Inc., to audit its books and to prepare a balance sheet as of December 31, 1923. The audit was made and the balance sheet prepared; attached to the balance sheet was a certificate in which the defendants attested to their examination and certified that the balance sheet represented in their opinion a true and correct view of the company's financial position as of December 31, 1923. Actually the defendants had negligently performed their work; the balance sheet prepared by them showed the Stern company a going concern with assets greatly in excess of liabilities, whereas had defendants' audit been carefully made, the balance sheet would have shown that the Stern company was insolvent.

Beginning in March, 1924, and continuing for the balance of the year, the plaintiff advanced to the Stern company large sums of money, relying upon the correctness of the balance sheet prepared by the defendants. In the latter part of 1924, the Stern company was adjudged a bankrupt, and part of the moneys advanced by the plaintiff were not repaid. This action was brought to recover the amount of these unpaid advances.

In the trial it was brought out that defendants did not know that the balance sheet was to be presented to plaintiff, though defendants did know that the statement might be presented generally by the Stern company as evidence of its financial condition. The court held: "To hold that defendants' duty extended not only to Stern, but to all persons to whom Stern might exhibit the balance sheet and who would act in reliance thereon, would compel defendants to assume a potential liability to practically the entire world. The law does not go so far, but limits the liability to those for whose direct benefit, to defendants' knowledge, the work for Stern was performed." *The Journal of Accountancy* remarks editorially, with unusual enthusiasm, that "the language of the decision may become classic" (see Vol. XLVIII, No. 2 [August, 1929], p. 126).

Part VIII—Investigations, New Financing, Accounting Advice¹

PROBLEM 89

THE NEW ENGLAND CORPORATION

Certification of Annual Profits

The New England Corporation has asked you to make an investigation of its accounts for three years, and to certify the annual profits for the respective years. The profits for the three years ended April 30, 1922, 1923, and 1924, as shown by its books of accounts, are as follows:

April 30, 1922	\$3,000,000
April 30, 1923 (Loss)	500,000
April 30, 1924	1,050,000

Your examination reveals that before the client arrived at the above amounts, it had deducted a Reserve for Contingencies of \$1,250,000 from profits in 1922, had in 1923 absorbed this entire reserve in the current Profit and Loss account and had set up another reserve of the same amount out of Surplus, and in 1924 had reduced this reserve by \$875,000 which it had credited to the current Profit and Loss account. On this basis your assistant in charge of the audit arrives at what he considers true profits, as follows:

Year ended April 30, 1922	\$4,250,000
Year ended April 30, 1923 (Loss)	1,750,000
Year ended April 30, 1924	175,000

On this basis the net profits for the three years have not only been incorrectly stated for individual periods, but have been overstated for the entire period by \$875,000. Your assistant further

¹ Because of lack of space, it has been necessary to omit from this volume a 65-page problem dealing with a financial and industrial investigation made for the purpose of purchasing a business. Accordingly, no problem dealing specifically with this phase of the auditor's work has been included.

states in his working papers, "A Reserve for Contingencies is nothing more nor less than surplus temporarily appropriated; operating losses should be charged against the operations of the year in which they occur. Consequently we believe that such reserves are chargeable against Surplus and should be credited back to that account when found to be no longer necessary."

When the three years' profits were ready for certification, the matter was discussed with the treasurer of the company. He admitted that the true profits for 1924 were only \$175,000 and that the transfer of \$875,000 from the Reserve for Contingencies should be credited back to Surplus, inasmuch as when the reserve was established it was charged against Surplus. However, he maintained that the \$1,250,000 credited in 1922 to a Reserve for Contingencies and charged against the earnings of that year was a segregation of net profits for some specific purpose, and he argued that no objection can be raised to returning the amount to the income of 1923, provided the facts are properly disclosed. He insists that the three years' profits be certified as follows:

Year ended April 30, 1922	\$3,000,000
Year ended April 30, 1923 (Loss)	500,000
Year ended April 30, 1924	175,000

As auditor for the corporation what position will you take? Discuss fully the reasons for your decision, and show the form in which you would desire to state the accounts for certification.¹

PROBLEM 90

GORWOOD MANUFACTURING COMPANY

Investigation of Inventories and Cost-Finding Methods

The Gorwood Manufacturing Company, which manufactured heavy hoisting machinery, maintained its general and sales offices

¹ It is important to observe that in certifying to profits the accountant certifies to actual profits and not to estimated or anticipated profits. As emphasis of this the following is quoted from the letter of a leading practitioner to a client, stating his firm's attitude toward giving estimates of future earnings; the quotation follows:

"We gather it is clearly understood by you that our part in the preparation of this memorandum is limited to assisting the officers of the company, but it is so fundamental a point of policy with us not to make or assume responsibility for any estimates of future earnings that we think it desirable to bring the point especially to your notice . . . so as to avoid any possibility of the estimate being inadvertently referred to as our firm's estimate. We are, of course, glad to assist, so far as we can, in getting material which is to be embodied in the application into proper form."

in lower New York, its factory in Brooklyn, and a large foundry in a neighboring town. The company had suffered heavy losses in the past several years, and because of this the stockholders employed Messrs. Adams, Browne & Company, Certified Public Accountants, to make an investigation of the business, covering a five-year period; they requested that special attention be given to the inventories and cost-finding methods. The company had total assets approximating \$4,500,000 and had annual sales of about \$3,000,000. After a preliminary survey of the business the auditors were satisfied that, except for the inventory situation and the cost-finding methods, the business was being operated with reasonable efficiency.

The auditor inspected all the storerooms, observed the methods of storing products in the bins, the numbering and marking on each bin, etc. There were four of the storerooms, and aside from the fact that the rooms were widely scattered and that their location was not the best, the stores seemed to be in good condition. Each bin was numbered to correspond with cards kept in the office, and all bins were kept strictly under control. An inspection of the receiving methods, methods of requisitioning, returning unused material to stores, etc., showed them all to be satisfactory.¹

Minimum and maximum quantities were marked on the cards; purchase or manufacturing requisitions (purchase requisitions if the materials were to be bought, or manufacturing requisitions if they were to be made) were prepared by the stores department as the quantities approached minimum requirements. The requisition had then to be approved by the purchasing agent or by the production manager, respectively.

A physical inventory was taken at the close of each fiscal period and adjustments and corrections were made as necessary. The production manager and also the person in charge of the stores records estimated that the errors in the records did not amount to more than 3% of the inventory, and they believed the amount of error was very much less than that; the auditor's scrutiny of the inventory cards convinced him that the corrections did not amount to more than 1% to 2% of the inventory.

¹ See Jones, *The Administration of Industrial Enterprises*, Ch. XVII; Kimball, *Principles of Industrial Organization*, Ch. XII.

Except for the purpose of replenishing stock (as previously explained), no production order was put into process except on order from the New York office.

The production order was prepared in quadruplicate. The original was retained by the production department, the duplicate was sent to the cost department (the reverse side of this copy was used as a summary of the costs), the third copy was sent to the foreman of the department where the work was to be put into process, while the fourth copy served as a tracer and accompanied the order through the factory. Upon the completion of the order the quadruplicate copy, or tracer, had marked upon it the date the work was completed, and was then sent to the cost department. The production order contained full instructions concerning the articles to be made, and recorded the "allowable time" for each department or process through which work went.

Material requisitions and material return slips were prepared in duplicate, one copy together with the employees' clock tickets being sent to the cost department and from these the proper entries were made on the cost sheets for the direct material and labor costs (the cost details were entered on large sheets, and only a summary of the costs of a manufacturing order were entered on the duplicate production order). The time tickets were computed by tenths of an hour, the time being recorded on a periodograph.

All additional costs were compiled by means, (a) of machine rates, and (b) of general percentages of overhead then applied to the sum of the direct labor and machine cost.

The machine rates were supposed to have been scientifically determined. The rates were theoretically computed by taking the depreciation, insurance, taxes and repairs for machines, together with the power charges and an arbitrary rental figure (this latter figure being a 5% interest charge on the investment in land and buildings), and dividing the sum of such costs by the productive hours of the various machines. This gave an hour-cost figure, which had been found of little value, for the following reason:

Suppose, for illustration, there were ten 48-inch radial drills in the factory, each drill costing new \$1,500. Because these drills were purchased at different dates, they had depreciated book values ranging anywhere from \$1,500 down to \$300, and the

depreciation was computed upon the reduced value from year to year. The company computed the elements of cost separately for each machine; thus, the machine rates on some of these drills, in so far as the rates were affected by the depreciation charge, were approximately five times what they were on others—even though the productive hours for the machines were the same.

Because of the above inequality in machine rates the company had practically ignored these computations and had adopted figures arbitrarily determined. These figures often went to the opposite extreme, that is, the same machine hour-rate was used not only for different-age machines of the same productive capacity but also for machines of wholly different values and productive capacity. As an illustration of the latter, planers 72 inches by 16 feet, and planers 42 inches by 10 feet, were each assigned a uniform rate of \$1 per hour, and no one, apparently, knew whether or not \$1 was even approximately correct for either size of machine. Certain figures prepared by the company showed the real costs to range from 60 cents to \$2.50 per hour for these machines. Likewise, 4-spindle drills with 24-inch tables, and 14-spindle drills with 30-inch tables, were given a uniform rate of 40 cents an hour, almost arbitrarily determined. These two cases were typical of all the machine rates of the company. The accountants were informed by the production manager, furthermore, that from 75% to 90% of the company's orders were processed on the smaller machines.²

The remaining burden was known as general overhead; it was equal in amount to the direct machine cost, and was distributed to orders by means of a general percentage rate, which was determined for each department by dividing the amount of the general overhead by the sum of the direct labor cost and the machine cost. During the course of this investigation the auditors made several trips out through the factory, and invariably found 50% to 60% of the machines idle; large machines were almost invariably idle. No specific records of idle time were kept by the company, though such idleness could have been computed quite readily.

² Practically all work done by this company was obtained as a result of bids; the analysis revealed that the company was frequently unable to get work which would normally be processed on the smaller machines, whereas it was generally successful in getting the contracts requiring the use of the large machines—but invariably the company lost money on these latter jobs.

The general overhead percentage rates were determined as above outlined; a standard rate was then used for a considerable period. The standard percentage rates applied to orders in the various departments during the last year of the period under examination, and the actual percentages for these same departments were as follows:

<u>Department</u>	<u>Designation</u>	<u>Percentage Used</u>	<u>Percentage Actual</u>
Works Engineering	A	150	208.19
Pattern Shop	B	35	None computed
Machine Shop	C	40	38.01
Machine Shop	D	50	103.21
Machine Shop	E	65	47.13
Machine Shop	F	25	49.15
Blacksmith Shop	G	45	71.23
Carpenter Shop	H	30	58.93
Boiler and Heater Shop	J	60	97.44
Erecting Shop	K	40	78.52
Tool Room	L	45	131.35
General		75	162.16

The labor tickets, as punched on the clocks to show productive labor by jobs, also showed whether the man was employed on a machine, and gave the machine cost (which was entered on the ticket by one of the cost clerks out in the factory). This machine-cost time was posted, when the job was completed, to the respective cost sheets; it was also entered, daily for all jobs, on a summary sheet so that each day all machine cost was summarized by departments. For each department it was further divided between (a) goods made for sale on special order, (b) goods made for stock parts, and (c) capital construction. The machine cost was summarized then for the month, the percentage of general overhead to combined direct labor and machine cost was applied (this was done also on the cost sheets for separate jobs, in order that each might bear its proper cost), and thus the total cost (direct labor, machine cost, and general overhead) applicable to work done was ascertained.

Inasmuch as all direct labor was chargeable directly to production orders, all other labor became general overhead. The total machine cost plus the total general overhead which was absorbed during the period, compared with the actual gross machine cost plus the actual general overhead for the same period, gave the over or underabsorbed burden expense of the period. This over or underabsorption was closed periodically into the

burden adjustment account in the general ledger; during each of the years under investigation there had been a large amount of unabsorbed burden; yet the company's costs were so much higher than competitors' that business could be neither obtained nor held. The burden unabsorbed during each of the five years was as follows:

Last year	\$246,726.21
Second year back	364,828.43
Third year back	213,121.65
Fourth year back	208,194.51
Fifth year back	131,203.43

During the course of the investigation the accountants further ascertained that the capital stock of the company was held solely by the four children (two brothers and two sisters) of the founder of the business, that each was financially independent of the business (though the brothers gave most of their time to it), and that the secretary and general manager of the business was a man considerably past sixty, and an old and intimate friend of the family, who had steadfastly followed his own course regarding the conduct of the business.

Outline what the accountants should report to the stockholders concerning the findings of their investigation.³

PROBLEM 91

GOOD-SERVICE BUS COMPANY

Special Investigation to Determine the Sufficiency of the Depreciation Provision

The Good-Service Bus Company, a corporation operating buses in Buffalo, New York, and within a radius of 50 miles to neighboring towns, has requested its public accountants, Messrs. Smythe, Browne & Co., 120 Broadway, New York City, to report on the sufficiency of the annual depreciation charges on the equipment and other property of the company used or necessary in rendering service to the public. The methods of determining the amount of this charge, as well as the sufficiency of the total accumulated provision for depreciation, are also to be given

³ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 64-66,

special consideration; the entire report is to be used in presenting the company's case to the New York rate-making body.

The property of the Good-Service Bus Company consists of buses capable of carrying 12 to 30 passengers, miscellaneous equipment incidental to transportation operations, garages and land, machinery and tools for construction and repair work, furniture in the office, restaurant and drivers' room, etc. The fixed property of the company is all located in the one city; it is shown in the balance sheet at June 30, 1924 (the date of the last annual report to the State Commission) at book values as follows:

Land used for business purposes	\$ 288,632
Garages on above land	761,378
Buses	773,008
Chassis converted to snow plow	9,475
Shop equipment	70,903
Restaurant and drivers' room equipment	4,591
Office furniture	13,200
Miscellaneous equipment	68,040
Organization expense	None
Patent rights	None
	<u>\$1,989,227</u>

These book values represent, in substantially all details, the actual cost of property now in or fit for service. The figures include no expenditures made prior to December 31, 1908. The miscellaneous equipment consists of automobiles and specially fitted service equipment, including badges and other incidentals; however, practically all of the value is in the service equipment.

The provisions for depreciation have been 2% per annum on the garage buildings, and 10% per annum on the shop machinery and tools, office equipment, etc. In respect to buses and miscellaneous equipment the maintenance expenditures and depreciation charges each year are combined, the gross figure for that year being determined on the basis of the aggregate revenue and non-revenue bus miles for the year at these rates:

Year ending June 30, 1920	5.75 cents
" " " " 1921	8.25 "
" " " " 1922	8.25 "
" " " " 1923	8.25 "
" " " " 1924	9.50 "

The effect of this practice (cents omitted) has been as follows:

Year to June 30	Maintenance Outlays	Depreciation		Total Maintenance and Depreciation
		Buildings, Tools, and Office Equipment	Buses and Miscellaneous Equipment	
1920	\$243,446	\$ 8,232	\$ 37,556	\$289,234
1921	330,050	14,820	103,398	448,268
1922	388,582	15,056	65,140	468,778
1923	475,675	19,640	1,990 ¹	493,325
1924	400,031	20,482	159,980	580,493 ²

Besides the depreciation on buses thus provided, there was an additional provision in the year ending June 30, 1922, of \$64,358.28 which was charged to corporate surplus.

Separate depreciation reserves are carried for: (1) buildings; (2) shop machinery and tools (including office and restaurant equipment); and (3) buses and miscellaneous equipment. The reserve for buses and miscellaneous equipment is described as "accrued amortization of capital" and the changes therein during the five years to June 30, 1924 have been as follows:

Year to June 30	Balance at Beginning of Year	Provisions during Year	Charges against Reserve	Balance at End of Year
1920	\$298,557	\$ 37,556	\$93,655	\$242,458
1921	242,458	103,398	58,064	287,792
1922	287,792	{ 64,358	18,944	398,346
		{ 65,140		
1923	398,346	1,990 ¹	1,046	395,310
1924	395,310	159,980	10,052	545,238

The charges against the reserve represent the book values, less salvage, of all equipment acquired since December 31, 1908, which was retired from service in the respective years.

Even though depreciation had not been accrued on all items of equipment dismantled for the total difference between the book value and the salvage value, this difference was charged to the

¹ Deduction entered in red. ² See footnote 3, page 443.

accrued amortization of capital account because the company's experience had demonstrated that over a period of years the provisions for depreciation were sufficient to care for the dismantlements made. In some cases the provision was less than the difference between the book value and the salvage value of the property, whereas in other cases the property had lasted longer than originally estimated and the total accrued depreciation provision was more than sufficient. The company therefore had adopted the procedure outlined, because it was in accordance with the rulings of the Public Service Commission in its uniform classification of accounts, and also because on the basis of averages the method was satisfactory.

The following condensed summary shows the condition of the capital assets and depreciation reserves at June 30, 1924:

Description	Book Value of Property	Reserve for Depreciation	
		Amount	% of Book Value
Land	\$ 288,632		
Garages	761,378	\$ 58,430	7.66%
Buses and miscellaneous equipment	850,523	545,238	64.10
Equipment in shop, restaurant, etc.	88,694	42,496	47.91
Total	\$1,989,227	\$646,164	32.48%

The company in its shops did practically no business other than that involved in the construction of special parts and the maintenance of buses for its own service. The accuracy with which these costs are determined or the correctness of the treatment generally was not tested; it was agreed that the accountants should assume that the net figures reported to the State Commission represented the actual costs of maintenance of property used in or incidental to transportation operations.

Messrs. Smythe, Browne & Co., having obtained the above information, proceed to give their attention, first, to the requirements of the State Commission; secondly, to the annual provisions for depreciation; thirdly, in so far as it is an accounting matter, to the accumulated amount in the reserve for depreciation.

Depreciation Requirements of the New York Public Service Commission

The New York Public Service Commission had not prescribed a uniform system of accounts precisely applicable to bus transportation; the uniform system of accounts for street and electric railways had been adapted by the company to its peculiar conditions. The principal changes necessary were in the maintenance accounts; in place of the detailed maintenance of way and structures and maintenance of equipment primary accounts prescribed for railways, the company had set up primary accounts for maintenance of plant and equipment suitable to its own needs.³

The uniform system of accounts requires, as regards depreciation, or accrued amortization of capital, the setting up of a reserve against which is to be charged the original money cost, less salvage, of any capital retired from service. The depreciation provisions charged to operating expenses and credited to the reserve are to be arrived at by subtraction from the amount "estimated to be necessary to cover such wear and tear and obsolescence and inadequacy as have accrued . . ." of the amounts of expenditures charged to maintenance. The net amount charged to operating expenses and credited to the reserve "must be sufficient to provide in that account, in respect of the several items of equipment by the time such items go out of service, a reserve equal to the original cost thereof, less salvage."

³ These primary accounts, together with the information obtained annually for each, were as follows (figures are for year ending June 30, 1924):

Maintenance Account	Year ended June 30, 1924	Per Bus Mile	Per Bus Hour
Superintendence	\$ 55,607.23	0.957¢	\$0.11584
Repairs of Buildings and Fixtures	16,754.22	.288	.03556
Repairs of Shop Tools and Machinery	980.68	.017	.00204
Shop Expenses	22,044.82	.379	.04648
Repairs of Bus Bodies—Material	33,544.29	.578	.06936
Repairs of Bus Bodies—Labor	50,968.95	.878	.10536
Repairs of Bus Chassis—Material	76,831.29	1.323	.15976
Repairs of Bus Chassis—Labor	105,890.51	1.823	.21976
Repairs of Service Cars	1,923.96	.033	.00496
Depreciation of Tires	35,485.19	.611	.07332
Depreciation of Equipment	159,979.86	2.754	.33048
Depreciation of Shop Tools and Machinery	6,465.73	.111	.01332
Depreciation of Buildings	14,016.44	.241	.02992
Total Maintenance	\$580,493.17	9.993¢	\$1.20618

The amount estimated to be necessary to cover wear and tear, etc., is to be based on a rule determined by the accounting corporation; the accrual may be on the basis of revenue mileage.

Several years have elapsed since there had been a revision of the classification, a period during which changing conditions and modifications of methods have been notable. Accordingly, it will probably be in order to submit to the Commission for approval any plan which secures the objectives which are clearly indicated in the text of the classification.

The Public Service Commission, First District, of the State of New York issued under date of December 19, 1923, a Uniform System of Accounts for Electrical Corporations. This Uniform System, while applicable to another class of utilities, has significance in being the most recent and indeed the only recent classification issued by either of the New York State Commissions. Inasmuch as formerly the classifications prescribed by the Public Service Commissions for the First and Second Districts, respectively, were very similar to each other in the substance of their requirements, the provisions in the recent issue regarding retirements are important. In this classification, in place of the depreciation reserve or a reserve for accrued amortization of capital, a "retirement reserve" is provided and it is prescribed that this reserve shall be credited with such amounts as are charged to the operating expense account "retirement expense" or are appropriated from surplus to cover the retirement loss represented by the excess of the original cost, plus cost of dismantling, over the salvage value of fixed capital retired from service. It is further prescribed that if the credit balance in the retirement reserve is insufficient to cover the retirement loss the excess of loss over the balance in the reserve should be charged to a debit account, "Property Abandoned," or other appropriate account. It is expressly stated that the purpose of the retirement reserve is "that the burden of such losses may be as nearly as is practicable equalized from year to year."

In commenting upon the above prescribed classifications the accountants state as follows:

The objectives in the Uniform System last cited are practically the same as those in the classification which is followed by the company, though the methods differ somewhat.

The notable objective in each classification is that the provisions for depreciation must be sufficient to meet the full cost at retirement of units surviving throughout the whole of their respective normal terms of life; also, there must be sufficient excess to provide for the unamortized balances on units retired in advance of their respective terms inasmuch as no provision is made for writing off the residual values of each retired unit not fully depreciated to operating expenses or surplus. While the classifications permit charges to surplus, it is clearly desirable and proper that the necessary provisions be made current charges to operations.

It is clearly preferable to deal with buildings and shop machinery and tools on a yearly basis regardless of operations; the bus mileage does not measure the activities in the shops and no satisfactory unit of use could probably be applied without an amount of analysis quite disproportionate to the annual charges. As regards the buses there is, however, a very close relation between service and wear and tear; it is very doubtful whether or not decay is a material factor, though obsolescence must be considered. The method of providing for buildings and machinery, etc., on a percentage basis and buses on a mileage basis is probably the most satisfactory.

There is a question whether or not, if the Commission were to prescribe a separate set of accounts for motor bus companies, it would have prescribed the practice of your company in basing the depreciation rates on all mileage, both revenue and non-revenue. Considerable latitude is allowed by the Commission, however, and probably the practice of your company is within the spirit of the instructions. While the inclusion of the non-revenue mileage tends to lose sight of the truly functional character that is the best justification for the use of revenue mileage alone, the actual effect of the inclusion of the non-revenue mileage on the basic rate is relatively small and the question is immaterial.

There is also a question whether or not the Commission would have grouped together the maintenance of all the property and equipment of the company, as has been done by your company. It might not have done so because the buildings and fixtures and the shop tools and machinery pertain to the operations of the company less exclusively than do the shop tools and machinery of the ordinary electric railway company, by reason of the fact that your shops do a small amount of outside work.

It is suggested that the upkeep and depreciation on buildings and of shop machinery and tools be dealt with separately from each other and from the corresponding expenses pertaining to vehicles and that the rate per bus mile for maintenance and depreciation be applicable only to the expenses other than the upkeep and repairs of buildings and machinery. To accomplish this an allocation, arbitrary if necessary, of certain expenses, superintendence for example, would have to be made between shop and transportation expense; with such a separation the sub-division of the total maintenance and depreciation estimates as between those applicable to buses and those applicable to buildings and machinery could be readily made. This has not been attempted in the present memorandum.

Adequacy of Depreciation Rates Employed

In determining the adequacy of the depreciation rates employed, it must be remembered that a bus in running condition consists of three parts, the chassis, the body, and the engine, which, when segregated for purposes of general repairs, are often not reassembled in the same combinations. The three therefore should be considered separately.

Shortly before Messrs. Smythe, Browne & Co. began this special investigation, the company had prepared special records wherein each chassis, each body, and each engine acquired for the company's use since the beginning of the business were entered at their cost, and in which was indicated the subsequent disposition of each of those later retired. From these records the accountants compiled figures regarding the average life of the retired units, and also the average life of those still in service at June 30, 1924, to which date all retirements were included. The results of this compilation are as follows:

Description	Units Retired	Units in Service June 30, 1924	Average Number of Years in Operation	
			Units Retired	Units in Service June 30, 1924
Chassis	158	363	5.18	6.42
Bodies	147	363	4.07	5.26
Engines	176	422	6.35	4.54
All units	481	1,148	5.38	5.31

However, certain experimental types, reconstructed units, and so forth, are included in the above; the accountants accordingly commented to the effect that:

the average life of the units that have been retired would seem to have been unduly reduced by the inclusion of certain experimental types, such as chassis of the "Q" type, which were acquired in 1917 and withdrawn from service during the years ended June 30, 1919, 1920, and 1921. This explains the shorter life of the chassis retired than the average life of those still in service; apparently the same principle applies to the bodies. It will be noted that a smaller number of bodies than chassis were retired and a smaller number of chassis than engines, and that the average age

of the bodies retired was 4.07 years, while that of those remaining in active service is 5.26. The average life of engines retired would have been a year or more greater had certain Achilles engines purchased in 1918 and scrapped during 1920 been left out of consideration.

The accountants' report continued:

As regards the units in service the average age of the chassis is increased somewhat by the inclusion of 25 which were acquired prior to January 1, 1912, but which have been reconstructed. There are the same number of bodies as of chassis and the average age of those in service does not appear to call for comment. The average age of the engines in service, namely 4.54 years, is considerably reduced by the recent acquisition of a number of engines, giving the company a stock in excess of normal requirements. We are informed by the engineering department that for safety the number of engines should exceed the number of chassis and bodies by about 15%; had the stock been limited to this excess the average age of those in service would have been higher.

If we assume, therefore, as it would seem reasonable to do, that the prospects of life of each of the units in the future will be greater than that of those which have been in the past acquired and retired, the experimental stage having now presumably been passed, it would seem that the 6-year life of a bus as a whole is, on historical grounds, an ultra-conservative estimate; that a 7-year life would still be over-conservative, as it is scarcely conceivable that the coaches in service at June 30, 1924, had on an average only a trifle more than one and one-half year's expectation of life; and that an 8-year life would be a very reasonable estimate. Taking into consideration that bodies are susceptible of rebuilding to make good the damage resulting from wear and tear and decay almost indefinitely, unless the type becomes obsolete, it is quite possible that a fair estimate of the life of a bus as a whole may be in excess of 8 years; however, the historical basis does not afford sufficient light on the matter to justify more than such an estimate and recourse must be had for this purpose to engineers' estimates based on observation of the actual condition and adequacy of the equipment in service.

The accountants then made computations to obtain estimates of the fair combined maintenance and depreciation requirements of the company, both on buses and other property, and of the amount per bus mile which these estimates represent.

Maintenance Expenditures:

Year to June 30, 1922	\$ 388,582
“ “ “ 1923	475,675
“ “ “ 1924	400,031
	<u>\$1,264,288</u>

Of which one-third, or average, is \$ 421,429

Depreciation - Buildings:	
2% on \$761,378, the investment at June 30, 1924	15,228
Depreciation - Shop, Office, and Restaurant Equipment:	
10% on \$88,694, the investment at June 30, 1924	8,869
Depreciation - Miscellaneous Equipment:	
Investment, June 30, 1924	<u>\$ 77,515</u>
Salvage value uncertain and may be covered by term of life estimated on 4-year life basis - annual provision	19,379
	<u>\$ 464,905</u>

Depreciation - Buses:

Investment, June 30, 1924	\$773,008
Less: Salvage, 363 buses at \$80	29,040
	<u>\$743,968</u>

Alternatives:

Annual provision on 6-year life	\$ 123,995
" " " 7-year life	106,281
" " " 8-year life	<u>92,996</u>

Total Maintenance and Depreciation Estimated as shown -

Alternatives:

On 6-year life of buses	\$ 588,900
On 7-year " " "	571,186
On 8-year " " "	<u>557,901</u>

The alternative results were then computed in terms of cents per bus mile; the performance of 5,901,286 total and 5,808,964 revenue bus miles for the year ending June 30, 1924, was taken as a basis, as follows:

	Per Revenue and Non-Revenue Bus Mile	Per Revenue Bus Mile
On 6-year life of buses	9.98¢	10.14¢
On 7-year " " "	9.68	9.83
On 8-year " " "	9.45	9.60

The above computations were included in the report to the client, the accountant commenting as follows upon them:

In arriving at the estimate for maintenance outlays, it was noted that the three years taken in consideration, ending June 30, 1924, reflect not only a fairly consistent price level but also, apparently, a consistent policy regarding repairs. Depreciation of buildings and of shop, office, and restaurant equipment are computed on the entire book investment; some portion of these provisions, however, is properly chargeable to the cost of work done in the shop, but this, as we have already mentioned, is a phase of the situation that we have not considered.

Depreciation of miscellaneous equipment has been based on an average 4-year life of units which are very diverse in character; it is difficult, therefore, to form more than an approximate estimate. The salvage

value of the units is uncertain, so instead of deducting anything from the investment in arriving at the depreciable portion, consideration has been given to salvage in the adoption of 4 years as the average term of life.

Adequacy of the Accumulated Reserves

Finally, the accountants considered the adequacy of the reserve for depreciation of buses and miscellaneous equipment on the basis of the facts and deductions already made with reference to the question of annual rates of depreciation. In this respect they reported as follows:

Competent physical observation combined with historical study afford means to determine whether or not the reserve at a given date is adequate. This memorandum deals with the question from the historical angle only.

As shown in this report the buses and miscellaneous equipment were carried June 30, 1924, at a cost value of \$850,523 and there was in the depreciation reserve, in respect to this investment, a balance of \$545,238, or 64.10% thereof. The motor buses, including all chassis, bodies, and engines, except those in work service, etc., were carried at \$773,008. We have shown that 5.31 years was the average age of all units in service, whether chassis, bodies, or engines at June 30, 1924. On this basis we may present the following computations as at June 30, 1924:

	Proportion of Life Expired	Corresponding Proportion of Value Less Salvage
On basis of 6-year life	5.3/6.0	\$657,172
" " " 7-year life	5.3/7.0	563,290
" " " 8-year life	5.3/8.0	492,879

To these must be added an estimate in respect to miscellaneous equipment which may be taken somewhat arbitrarily as two-fifths of the cost value, or \$31,006. The total reserve required at June 30, 1924, may be stated on the basis described as:

On basis of 6-year life for buses	\$688,178
" " " 7-year " " "	594,296
" " " 8-year " " "	523,885

While all of these figures are based on estimates, they all justify the company carrying the reserve of \$545,238.

Examine critically the methods adopted by the accountants in this case, the figures and arguments given, and the results obtained. Are the conclusions reached justified by the materials presented? Give reasons for your answer.

PROBLEM 92

AMERICAN INSTITUTE OF ACCOUNTANTS

Balance Sheets Giving Effect to Financing

The following is the report of the Special Committee on Cooperation with Bankers, of the American Institute of Accountants, as submitted in September, 1923:¹

AMERICAN INSTITUTE OF ACCOUNTANTS
REPORT OF THE
SPECIAL COMMITTEE ON COOPERATION WITH BANKERS

New York, September 10, 1923.

To the Council of the American
Institute of Accountants.

Gentlemen:

The Special Committee on Cooperation with the Bankers has given careful consideration to the question referred to it by the council of the Institute regarding the certification of balance sheets giving effect to transactions consummated at a date later than the date of the balance sheet.

The practice which dates back some twenty years or more, but at that time was rarely resorted to, has in recent years become the rule rather than the exception in the case of balance sheets prepared in connection with new financing. The question was reported upon by the Special Committee on Procedure at the September, 1920, meeting of the council, but since that time the practice has grown to such an extent that your committee feels it is now in order to deal with it somewhat more fully and, further, the question of the accountants' position with regard to such statements has recently been raised by the Robert Morris Associates committee.

Your committee has carefully considered the advantages to the issuing houses and the investing public of such a form of certification as well as the objections to and dangers of the procedure. The committee is convinced that as a practical matter accountants are confronted with a condition and not a theory, and that the preparation and certification of such statements properly falls within the field of the accountant's work.

It is manifest, however, that such statements should only be issued under proper safeguards and rules for the guidance of the members of

¹ See *The American Accountant*, November, 1928, pp. 34-37.

the profession to insure as far as possible sound standards and uniformity of practice.

Your committee, of course, realizes that such rules should be broad and sufficiently elastic to allow of the exercise of initiative in dealing with unusual situations which will inevitably arise in connection with such a question.

Your committee accordingly recommends the following general rules for the guidance of the members of the Institute with reference to the issuance of such statements and certificates:

I. The accountant may certify a statement of a company giving effect as at the date thereof to transactions entered into subsequently only under the following conditions, viz.:

- (a) If the subsequent transactions are the subject of a definite (preferably written) contract or agreement between the company and bankers (or parties) who the accountant is satisfied are responsible and able to carry out their engagement;
- (b) If the interval between the date of the statement and the date of the subsequent transactions is reasonably short—not to exceed, say, four months;
- (c) If the accountant, after due inquiry, or, preferably after actual investigation, has no reason to suppose that other transactions or developments have in the interval materially affected adversely the position of the company; and
- (d) If the character of the transaction to which effect is given is clearly disclosed, i.e., either at the heading of the statement or somewhere in the statement there shall be stated clearly the purpose for which the statement is issued.

II. The accountant should not certify a statement giving effect to transactions contemplated but not actually entered into at the date of the certificate, with the sole exception that he may give effect to the proposed application of the proceeds of new financing where the application is clearly disclosed on the face of the statement or in the certificate and the accountant is satisfied that the funds can and will be applied in the manner indicated. It is not necessary that the precise liability shown in the balance sheet before adjustment should actually be paid out of the new money. It is sufficient, for instance where the balance sheet before the financing shows bank loans, if the proceeds are to be applied to bank loans which are either identical with or have replaced the bank loans actually outstanding at the date of the balance sheet. Ordinarily, however, the accountant should not apply the proceeds of financing to the payment of current trade accounts payable, at least not against a normal volume of such current accounts payable, because there must always be such accounts outstanding and the application of new moneys against the outstanding at the date of the balance sheet results in showing a position which in fact could never be attained. The accountant may usually

best satisfy himself that the funds will be applied as indicated by getting an assurance from the issuing house on the point.

III. In any description of a statement or in any certificate relating thereto it is desirable that the past tense should be used. It should also be made clear that the transactions embodied have been definitely covered by contracts.

IV. When the accountant feels that he cannot certify to such a hypothetical statement, probably because of the length of the period which has elapsed since the accounts have been audited, he may be prepared to write a letter, not in certificate form, stating that at the request of the addressee a statement has been examined or prepared in which effect is given, in his opinion correctly, to proposed transactions (which must be clearly specified). Such letters should be given only in very special cases and with the greatest care.

The committee illustrates the special form of statement and certificate, and also of the letter coming within the terms of Rule IV, as follows:

FORM OF BALANCE SHEET AND CERTIFICATE WHERE CONDITIONS
LAID DOWN IN RULES I AND II HAVE BEEN MET

A. B. C. COMPANY

BALANCE SHEET, DECEMBER 31, 1922

(Giving effect as at that date to the sale of \$5,000,000 first mortgage bonds since consummated and the application of the proceeds in part in reduction of liabilities.)

ASSETS

LIABILITIES

We have examined the books and accounts of the A. B. C. Company for the year ended December 31, 1922, and the agreement dated March 2, 1923, for the sale of \$5,000,000 first mortgage bonds, and we certify that the above balance-sheet is, in our opinion, a fair and accurate statement as of December 31, 1922, of the financial position of the company, giving effect at that date to the provisions of the agreement mentioned.

New York, March 2, 1923.

.....

LETTER COMING WITHIN TERMS OF RULE IV

New York, August 25, 1923.

Mr. John Smith, Vice-president,
A. B. C. Company,
52 William Street,
New York City.

Dear Sir:

In accordance with your request, we have examined the attached balance-sheet of the A. B. C. Company as of June 30, 1923, and beg to advise you that in our opinion it is prepared so as to reflect correctly the position of the company as shown by the books, but giving effect as at that date to the pending issue of \$300,000 first mortgage bonds as provided in the agreement dated August 25, 1923, and to the extinguishment out of the proceeds of the new financing of the notes payable to bankers to the amount of \$300,000.

It will be understood that we have not audited the books since the close of the fiscal year on December 31, 1922. You have heretofore been furnished with the audited accounts as of that date, which were in accord with the books.

Yours very truly,

.....

Respectfully submitted for the Special Committee on Cooperation with the Bankers.

WILLIAM B. CAMPBELL,
Chairman.

Discuss the report of the Committee on Cooperation with Bankers. In what way do the procedures contemplated thereby differ from the regular work of the auditor?

PROBLEM 93

A.B.C. IRON COMPANY

Certification for New Financing

You are asked on April 20, 1928, by Messrs. Rogers and See, Investment Bankers, and by the A.B.C. Iron Company to certify the consolidated balance sheet of the A.B.C. Iron Company and Subsidiary Companies as at December 31, 1927, but after giving effect to proposed financing as specified in a contract entered into by the above parties under date of April 18, 1928.

The balance sheet as of December 31, 1927, which you certified as a result of your audit for the period ended as of that date, is as follows:

A. B. C. IRON COMPANY AND SUBSIDIARY COMPANIES
Consolidated Balance Sheet as of December 31, 1927

<u>ASSETS</u>			
<u>COST OF PROPERTIES</u>		\$18,800,000.00	
Less: Reserves for depreciation, depletion, etc.		4,800,000.00	
			\$14,000,000.00
<u>CURRENT ASSETS:</u>			
Inventory of pig iron, ore, supplies, etc., at cost or market, whichever was lower	\$ 2,000,000.00		
Accounts and notes receivable (less reserve)	300,000.00		
United States Treasury Bonds, at cost	300,000.00		
Municipal and other bonds	60,000.00		
Cash in banks and on hand	140,000.00		2,800,000.00
<u>DEFERRED CHARGES:</u>			
Discount on bonds	\$ 130,000.00		
Royalties paid in advance	100,000.00		
Prepaid insurance, taxes, etc.	70,000.00		300,000.00
			<u>\$17,100,000.00</u>
<u>LIABILITIES</u>			
<u>CAPITAL STOCK:</u>			
Common - authorized and issued - 60,000 shares of \$100 each	\$ 6,000,000.00		
Preferred - authorized 40,000 shares of \$100 - issued 15,000 shares	1,500,000.00		\$ 7,500,000.00
<u>FUNDED INDEBTEDNESS:</u>			
5% First Mortgage Bonds, due 1935	\$ 2,000,000.00		
5½% First and Refunding Mortgage Serial Gold Bonds due 1947	3,000,000.00		
7% Debentures due 1928	1,000,000.00		6,000,000.00
<u>CURRENT LIABILITIES:</u>			
Notes payable	\$ 2,100,000.00		
Accounts payable	650,000.00		
Accrued royalties	30,000.00		
Accrued bond interest	20,000.00		
Accrued taxes and miscellaneous	100,000.00		2,900,000.00
<u>RESERVES:</u>			
For relining blast furnaces	\$ 150,000.00		
For contingencies	250,000.00		400,000.00
<u>SURPLUS</u>			300,000.00
			<u>\$17,100,000.00</u>

Two notes appeared on the balance sheet, as follows:

- (a) The company is contingently liable on December 31, 1927, on account of notes discounted aggregating \$350,000.
- (b) Cumulative preferred dividend of $3\frac{1}{2}\%$ unpaid at October 15, 1927.

The contract for the proposed new financing (referred to above) was carefully examined by you and was found to provide for the sale of \$3,000,000 6% General and Refunding Mortgage Bonds, due April 15, 1952, for the issue at par of \$1,000,000 additional preferred stock, and for the application of the proceeds (a) in liquidation at par of the 7% Debentures due in 1928, (b) to the payment of notes and accounts payable aggregating \$2,500,000, and (c) as additional cash resources. The total discount and expense of the new financing was \$270,000.

Prepare the consolidated balance sheet to give effect to the proposed financing, and the certificate you would be willing to sign.¹

PROBLEM 94

S. D. MANN COMPANY

Certification of Accounts for Financing

The general laws under which corporations are organized in Massachusetts require the incorporators to file articles of organization with the commissioner of corporations showing, among other things,

The amount of capital stock then to be issued, the amount thereof to be paid for in full in cash, the amount thereof to be paid for in cash by instalments and the instalment to be paid before the corporation commences business, and the amount thereof to be paid for in property. If such property consists in any part of real estate, its location, area, and the amount of stock to be issued therefor shall be stated; if any of such property is personal, it shall be described in such detail as the commissioner may require, and the amount of stock to be issued therefor stated. If any part of the capital stock is issued for services or expenses, the nature of such services or expenses and the amount of stock which is issued therefor shall be clearly stated.

¹ See Himmelblau, *Auditors' Certificates*, pp. 72-87.

Upon the approval by the commissioner of corporations of the articles of organization and of other matters relative to the organization of the corporation, and the payment of the statutory fee, the articles are filed in the office of the state secretary, who causes them and the indorsement thereon to be recorded. The state secretary then issues a certificate of incorporation in the following form:

COMMONWEALTH OF MASSACHUSETTS
CHARTER¹

Be it known that whereas (the names of the subscribers to the agreement of association) have associated themselves with the intention of forming a corporation under the name of (the name of the corporation), for the purpose (the purpose declared in the agreement of association), with a capital stock of (the amount fixed in the agreement of association, with a statement of the several classes into which the stock is divided and their respective amounts, and of the method of paying for such stock, whether by cash in full, cash in instalments, property, services, or expenses, or partly by one method and partly by another or others), and have complied with the provisions of the statutes of this Commonwealth in such case made and provided, as appears from the articles of organization of said corporation, duly approved by the commissioner of corporations and taxation and recorded in this office; now, therefore, I (the name of the secretary), secretary of the Commonwealth of Massachusetts, do hereby certify that said (the names of the subscribers to the agreement of association), their associates and successors, are legally organized and established as, and are hereby made, an existing corporation under the name of (name of the corporation), with the powers, rights and privileges, and subject to the limitations, duties, and restrictions, which by law appertain thereto.

Witness my official signature hereunto subscribed, and the great seal of the Commonwealth of Massachusetts hereunto affixed, this.....day of.....in the year (the date of filing of the articles of organization).

The state secretary signs the certificate of incorporation and causes "the great seal of the Commonwealth to be thereto affixed"; the certificate has the force and effect of a special charter, and is evidence of the existence of the corporation.

A. P. Couzens, a certified public accountant of Massachusetts

¹ If the corporation is organized with no-par-value capital stock, the form of the certificate of incorporation is modified to conform thereto. See North, *Corporation Handbook*, pp. 10-23 (published by Johnson & North, 89 State Street, Boston).

practising in Worcester, Massachusetts, was employed by M. A. Barr, Esq., an attorney-at-law, to assist in the organization of The S. D. Mann Company for Mr. Sharp D. Mann. Mr. Barr informed Mr. Couzens that because of Mr. Mann's reputation for sharp-dealing it was deemed advisable to show the capital stock of The S. D. Mann Company as fully paid in cash.

Thereupon Mr. Barr presented a balance sheet of The S. D. Mann Company, as prepared by Mr. Mann's bookkeeper, viz.:

THE S. D. MANN COMPANY
Balance Sheet, May 20, 1925

Cash on deposit	\$16,000.00	Demand Notes Payable . .	\$ 1,000.00
		Capital Stock	15,000.00
	<u>\$16,000.00</u>		<u>\$16,000.00</u>

Mr. Barr stated that Mr. Mann would bring all the books and records having to do with The S. D. Mann Company to his (Mr. Barr's) office; the following day Mr. Couzens examined the books of the new company and found in the ledger the three accounts given in the balance sheet above.

Mr. Couzens prepared the usual form for obtaining confirmation of the cash on deposit with the bank; this was signed by Mr. Mann, and was mailed by Mr. Couzens personally to the Xanthus Trust Company. Mr. Couzens had enclosed a self-addressed, stamped envelope for the reply.

The request for confirmation asked the bank to certify to the balance on its books, as of the close of business May 20, 1925, to the credit of The S. D. Mann Company. The bank was also specifically requested to furnish full particulars of any loans or advances made by it to The S. D. Mann Company that were unpaid as of this date, and also any items for which the company was contingently liable.

The bank certificate, signed by the treasurer of the Xanthus Trust Company, was received the next day by Mr. Couzens through the mail. It certified that The S. D. Mann Company had a balance of \$16,000 to its credit as of the close of business May 20, 1925; no mention was made of any actual or contingent liabilities.

A letter was also obtained by the auditor from Mr. Mann affirming that he had deposited in the Xanthus Trust Company \$16,000 to the credit of The S. D. Mann Company, of which \$1,000 was a personal loan to the company and \$15,000 was cash paid in for the capital stock (300 shares of common stock, of a par value of \$50 per share) which was to be issued to him. Mr. Mann also stated that the company had no other assets or liabilities, either actual or contingent.

On the basis of these confirmations, and of such other verification as could be made from the somewhat meager records, Mr. Couzens, on May 24, certified the balance sheet in the following form:

THE S. D. MANN COMPANY
 Balance Sheet, May 20, 1925
 (To give effect to 300 shares of Common Stock when issued)

Cash on deposit \$16,000.00	Demand Notes Payable . . \$ 1,000.00 Capital - 300 shares of Common Stock, of a par value of \$50 per share, to be issued 15,000.00
<u>\$16,000.00</u>	<u>\$16,000.00</u>

Mr. Couzens delivered the balance sheet to Mr. Barr, and received a check in full payment of his services.

Two days later Mr. Couzens met Mr. Mann's bookkeeper at lunch and the bookkeeper told him the following story:

Mr. Mann did not have the \$15,000 to pay for the stock of The S. D. Mann Company; he had therefore gone to the Xanthus Trust Company the day before the accountant had been engaged and had borrowed \$15,000 on his personal note. This \$15,000 he had deposited to the credit of The S. D. Mann Company on a certificate of deposit; the certificate, in turn, had been given to the treasurer of the Trust Company to secure the note. He then deposited an additional \$1,000 to the credit of The S. D. Mann Company for which he took the company's demand note. On the day that the certified balance sheet had been delivered to Mr. Barr, Mr. Mann had gone to the Xanthus Trust Company; as treasurer of The S. D. Mann Company he had the treasurer of

the Trust Company apply the certificate of deposit in payment of his personal note. Mr. Mann had then instructed his bookkeeper to make an entry debiting Accounts Receivable (S. D. Mann) and crediting Cash, for \$15,000.

Mr. Couzens went at once to the Xanthus Trust Company and saw the treasurer, who substantiated the story but added that the amount involved was relatively small; also that Mr. Mann would own all of the stock of the company, and that it was to his best interests to hold it permanently. Furthermore, the treasurer stated that the immediate profits probably would be large because of a contract which The S. D. Mann Company had obtained with another corporation. Then the treasurer added, "Anyway, why should you care? You have a clean certificate from us."

What should Mr. Couzens do in regard to the matter, assuming (a) that the commissioner of corporations has approved the company's papers, and the capital stock has been issued, and (b) that the company's papers have not been approved by the commissioner of corporations? Would your answers above be changed in any way if Mr. Couzens had not been paid?

PROBLEM 95

NEW DEVELOPMENT COMPANY

Giving Effect to Proposed Financing

The books and accounts of the New Development Company were audited as of December 31, 1927 by Messrs. Arthur, James & Co., 111 West Monroe Street, Chicago, Illinois; a certified balance sheet had been presented as a result of the audit. On March 13, 1928 the accountants certified to the above balance sheet again, but "after giving effect to a proposed issue of \$1,500,000 first preferred 7% stock." In the latter balance sheet the accountants gave effect to this new financing by deducting the entire \$1,500,000 from Notes Payable, though there was nothing in the statement to indicate that it was handled in this manner.

As a matter of fact, on the date the accountants certified the

statement "after giving effect . . ." etc., the issue of preferred stock had not actually been authorized by the stockholders; there was some delay in obtaining this authorization, so that the company did not receive the proceeds until the middle of June.

The company's bank had been furnished with a copy of the certified statement of December 31, 1927; the bank also received from the broker through whom the first preferred stock was sold a copy of the financing balance sheet of March 13, 1928. By comparing the two statements, and by inquiring of the broker, the bank learned that the accountant had applied the proceeds of the financing as indicated above. The bank maintained that the financing balance sheet was misleading; if the proceeds of the preferred stock were to be applied in reduction of the notes payable, so stated the bank, the entire amount of the notes payable should have been set up in the statement with the \$1,500,000 deducted, because when the March 13 statement came out it so happened that the commercial paper broker held notes in excess of the amount shown in the statement, to say nothing of the sum owed to the bank. Furthermore, maintained the bank, "any one may compute for himself how much of the proceeds received in June was used to retire notes payable that the company had outstanding on December 31 of the previous year."

Was the accountant in error in certifying the financing balance sheet on March 13, 1928? If so, in what respect? If not, explain why his act was in accordance with accepted accounting practice. If the accountant was correct in doing as he did, wherein was the banker in error?

PROBLEM 96

PENNSYLVANIA-DIXIE CEMENT CORPORATION

Balance Sheet Giving Effect to Sale of Securities

Pennsylvania-Dixie Cement Corporation was incorporated under the laws of the State of Delaware on September 16, 1926, to acquire the business and properties of the Pennsylvania Cement Company, Dexter Portland Cement Company, Dixie Portland Cement Company, and Clinchfield Portland Cement Cor-

poration. Each of these companies acquired by the new corporation had reported a profit for each of the preceding thirteen years; the Pennsylvania-Dixie Cement Corporation, by the acquisition of these companies, became one of the larger companies in the cement producing industry, owning seven plants with an aggregate productive capacity of ten million barrels of cement per annum. Approximately 1,750 workmen are employed.

The authorized capital stock of Pennsylvania-Dixie Cement Corporation consists of 1,000,000 shares of no-par-value common stock, and \$20,000,000 of 7% cumulative, convertible preferred stock of a par value of \$100 per share.¹ There was also authorized, at the time of the organization of the company, \$20,000,000 of 6% first mortgage bonds, dated September 15, 1926 and maturing September 15, 1941. During September, 1926, the date of the organization of the company, there was issued \$13,000,000 (Series A) of the first mortgage bonds at 99½ to yield 6.05%, \$13,000,000 (Series A) of the cumulative convertible preferred stock at 99 flat, and 400,000 shares (300,000 shares being offered to the public at \$43 per share) of the no-par-value common stock, to acquire the properties of the several related companies.² The preferred stock has since been listed on the New York Stock Exchange, and the common stock on the New York and Boston Stock Exchanges.

The preferred stock has preference as to assets and dividends. It is entitled to \$110 per share and accumulated dividends in case of voluntary liquidation, and to par and accumulated dividends in case of involuntary liquidation. It is redeemable at any time on thirty days' notice at \$110 per share and accumulated dividends. If four quarterly dividends are in default the preferred stock elects the majority of the directors; this continues as long as any dividends are in arrears. The preferred stock is convertible at any time into the no-par-value common stock, at the rate of one and one-half shares of common for each share of the preferred; so 195,000 shares of the no-par-value common stock have been reserved for the conversion of the Series A preferred stock.

¹ For details concerning the organization of the company see *Poor's Manual*, 1927, Industrial Section, pp. 711-713, and 1928, Industrial Section, pp. 2862-2864.

² Inasmuch as only 300,000 shares of the 400,000 shares of no-par-value common stock issued in September, 1926 were offered to the public, it is apparent that the other 100,000 shares must have been issued to the promoters and other "inside interests" having to do with the organization of the new company.

The prospectus which was issued during September, 1926, by the investment bankers, for the sale of the 300,000 shares of no-par-value common stock was headed as follows:

300,000 Shares

Pennsylvania-Dixie Cement Corporation (Incorporated under the laws of the State of Delaware)

Common Stock

<i>Transfer Agents</i>	<i>Registrars</i>
THE CHEMICAL NATIONAL BANK OF NEW YORK THE NATIONAL SHAWMUT BANK OF BOSTON	THE NATIONAL CITY BANK OF NEW YORK THE FIRST NATIONAL BANK OF BOSTON

It is expected that application will be made to list this Stock on the New York Stock Exchange

Capitalization

	Authorized	Presently to be Outstanding
First Mortgage Bonds, due 1941 . . .	\$20,000,000	
Series A, 6%		\$13,000,000
Cumulative Preferred Stock	20,000,000	
Series A, Convertible 7%		13,000,000
Common Stock (no par value)	1,000,000 Shares*	400,000 Shares

* Including 195,000 shares reserved for conversion of Series A Preferred Stock.

Then followed the summary of a letter from Mr. Richard Hardy, chairman of the board of directors of the Pennsylvania-Dixie Cement Corporation; the complete letter is given herewith:

Pennsylvania-Dixie Cement Corporation

New York, N. Y., September 18, 1926.

Lehman Brothers,
Hemphill, Noyes & Co.,
Caldwell & Company.

Dear Sirs:

I take pleasure in giving you the following information regarding Pennsylvania-Dixie Cement Corporation and its Common Stock:

Business and Property

Pennsylvania-Dixie Cement Corporation has been incorporated under the laws of the State of Delaware to acquire the business and properties of the following companies:

Pennsylvania Cement Company	Dexter Portland Cement Company
Dixie Portland Cement Company	Clinchfield Portland Cement Corporation

Each of these companies has reported a profit for each of the last thirteen years. Upon the acquisition of these properties, the Pennsylvania-Dixie Cement Corporation will become one of the larger companies in the cement producing industry, and will own seven plants with an ag-

gregate productive capacity of 10,000,000 barrels of cement per annum. In addition the Corporation, through subsidiaries, will produce and sell sand and gravel, limestone, and tile and other cement products.

The location of the cement plants and their present annual capacity as reported by Ford, Bacon & Davis, Inc., and Mr. Ellis Soper, are:

Location	Annual Capacity
Nazareth, Pa., Plant No. 1	1,300,000 barrels
Nazareth, Pa., Plant No. 2	1,100,000 "
Bath, Pa.	1,940,000 "
Portland Point, N. Y.	1,060,000 "
Richard City, Tenn. (near Chattanooga)	2,000,000 "
Kingsport, Tenn.	1,500,000 "
Clinchfield, Ga. (near Macon)	1,100,000 "
Total	<u>10,000,000</u> barrels

Each of the above-mentioned plants constitutes a complete unit, with large nearby reserves of high grade raw materials and efficient equipment for the quarrying, grinding and burning operations incident to the manufacture of Portland cement. All of the mill equipment, including the crushers, pulverizers and large rotary kilns, is electrically driven, power being secured in part from turbo-generator installations using waste heat from the kilns and in part under favorable contracts with electric power companies. Because of the quality and accessibility of the raw materials and the efficiency of the equipment installed, these plants produce cement at costs which are among the lowest of any plants in the country.

The geographical distribution of the plants is such that shipments can be made advantageously into the great consuming markets of the Middle Atlantic and New England States and into the rapidly growing markets of the South. These markets over a period of years have taken over 40% of the cement consumed in the United States. The geographical distribution of its plants also should promote greater stability of operation by minimizing the effect of unfavorable local conditions in particular sections.

Earnings

The combined earnings of the companies to be acquired by Pennsylvania-Dixie Cement Corporation, before deduction of special compensation and certain bonuses to be discontinued, and after depreciation, depletion, and all prior charges based on the new capitalization, including Federal income taxes at the rate of 13½%, as certified by Messrs. Price, Waterhouse & Co., Public Accountants, have been as follows:

Year Ended	Earnings (as above)	Earnings per Common Share (as above)
December 31, 1923	\$1,497,952	\$3.74
December 31, 1924	1,835,949	4.59
December 31, 1925	2,536,567	6.34
July 31, 1926	2,816,086	7.04

The number of barrels of cement sold during the twelve months ended July 31, 1926, represent increases of 4.3%, 14.6% and 31.2% respectively over the three preceding calendar years 1925, 1924 and 1923. During this period the annual capacity of the properties was enlarged by more than 3,000,000 barrels.

Balance Sheet

The consolidated balance sheet of Pennsylvania-Dixie Cement Corporation and subsidiary companies as certified by Messrs. Price, Waterhouse & Co., sets forth the financial condition as of July 31, 1926, of the combined properties and business to be acquired by the Corporation after giving effect to the transactions, including financing, incident to such acquisition. The net earnings of these properties from July 31, 1926, to the date of acquisition by the new Corporation, less certain organization expenses and other charges, will accrue to the benefit of the Pennsylvania-Dixie Cement Corporation. Land, buildings and equipment are carried at a net amount of \$26,053,446.56 after the deduction of depreciation of \$4,581,556.36, being the reproduction cost, less depreciation, as appraised by Ford, Bacon & Davis, Inc., as of June 30, 1926, and adjusted to July 31, 1926. The latter have appraised the commercial value of these properties, excluding working capital, as of June 30, 1926, at \$34,762,000.

Current assets, as shown on the above-mentioned balance sheet, are over 4.9 times current liabilities, net current assets amounting to \$6,024,865, or over \$.60 per barrel of capacity. Cash alone is more than twice the amount of total current liabilities.

Dividends

It is expected that dividends on the Common Stock will be initiated in the near future at the rate of \$3.20 a year.

Provisions of Senior Issues

The authorized amounts of First Mortgage Bonds and of Cumulative Preferred Stock are each \$20,000,000, of which \$13,000,000 of each class are being issued at this time. The remaining \$7,000,000 of Bonds may be issued in principal amount equal to but not exceeding 60% of the actual cost or fair value (whichever shall be lower) of any fixed property acquired, provided that the provisions as to earnings and as to net current assets defined in the mortgage are complied with.

The mortgage securing the Bonds will provide for a sinking fund commencing on August 1, 1927, requiring semi-annual payments equal to 1½% of the maximum principal amount of all Bonds theretofore issued, and, in addition, will require payment on August 1, 1927, and annually thereafter of an additional sum amounting to 15% of the aggregate net earnings of the Corporation for the preceding fiscal year remaining

after paying all dividends on the Preferred Stock during such fiscal year. As long as the Corporation has outstanding any Bonds issued under the First Mortgage, dated as of September 15, 1926, there will be no sinking fund for the Series A Preferred Stock. Upon the satisfaction of the mortgage mentioned, a sinking fund similar to that described above is provided for the Series A Preferred Stock.

The Series A Convertible 7% Cumulative Preferred Stock is convertible at any time at the option of the holder thereof into Common Stock of the Corporation at the rate of $1\frac{1}{2}$ shares of Common Stock for each share of Preferred Stock Series A so converted.

Purpose of Issue

The present financing is in connection with the acquisition of the properties comprising the Pennsylvania-Dixie Cement Corporation and to provide additional working capital. Substantial amounts of the Preferred and Common Stocks will be owned by interests previously identified with the properties now being acquired.

General

The first plant in the United States for the manufacture of Portland cement was built in 1872. Since that time there have been but four years in which the production of Portland cement failed to show an increase over the preceding year. At the present time there are 141 plants of varying capacities in operation employing over 40,000 workers and representing a plant investment in excess of \$450,000,000.

The growth of the industry may be attributed to the development of manufacturing processes, the adoption of standard specifications and the systematic study and development of new uses for cement. A comparison of the increases in the production of Portland cement with those of other commodities makes plain the rapid rate at which the cement industry has been growing. In the 20 years between 1905 and 1925 the output of Portland cement has increased over 350%, while in the same period the production of pig-iron has grown less than 60%, and lumber less than 25%.

The wide diversification of the sources of demand for cement is shown by the following classification of consumption for the year 1925, as prepared by "Concrete":

Uses	Per Cent.
Paving and Highways	27.5
Public and Commercial Buildings (including apartments)	26.0
Farm uses (including small towns)	18.0
Houses	8.5
Sidewalks and private driveways	5.5
Railways	5.5
Concrete Pipe	4.5
Miscellaneous (including bridges, dams, etc.)	4.5
	<u>100.00</u>

The most important use of cement as is evident from the table above is for highway construction. The demand for this purpose, which is increased from less than $\frac{1}{2}$ of 1% of the country's total consumption of 1910 to over 27% in 1925, may be expected to be particularly stable through good times and bad, as it is derived almost entirely from states, municipalities and other political sub-divisions. The potential growth of future demand for construction of roads is indicated by the following figures relating to the highway system and automobile registration of the country:

	Total Mileage All Roads	Surfaced Roads	Concrete Roads	Automobile Registration	
				Passenger	Trucks
1904 . . .	2,151,379	153,530		54,590	410
1909 . . .	2,199,645	190,476	20	305,950	6,050
1914 . . .	2,445,760	257,291	2,348	1,625,739	85,600
1921 . . .	2,941,294	387,760	15,991	9,346,195	1,118,520
1925 . . .	3,002,916	495,000	37,659	17,512,638	2,441,709

In spite of the tremendous growth of automobile registrations and the growing importance of motor transport, concrete roads at present constitute less than $1\frac{1}{2}\%$ of the nation's highways.

It is believed that the widely diversified demand for cement as indicated by the tabulation above, and the essential nature of the sources of demand assure the cement industry of a stable and increasing consumption of its product.

The management of the Pennsylvania-Dixie Cement Corporation will be composed of men identified with the predecessor companies in their past success and growth.

Application will be made, upon your request, to list this Common Stock on the New York Stock Exchange.

Very truly yours,

RICHARD HARDY,
Chairman.

The consolidated balance sheet of Pennsylvania-Dixie Cement Corporation and subsidiary companies, setting forth the financial condition as of July 31, 1926 of the combined properties and business to be acquired by the corporation after giving effect to the transactions, including the financing, incident to such acquisition, is as follows; both the balance sheet and the earnings, as adjusted, are certified by independent accountants:

Pennsylvania-Dixie Cement Corporation and Subsidiary Companies

Consolidated Balance Sheet, July 31, 1926

Giving effect as at that date to the formation of the new company, the issue and sale of its bonds and capital stock for properties and for cash, and the liquidation of certain liabilities of the predecessor companies incident to the financing.

ASSETS

Current Assets:	
Cash	\$ 3,370,444.92
Notes receivable (net)	195,914.40
Accounts receivable (net)	1,483,473.84
Due from officers and employees	63,399.32
Inventories at cost or market, whichever is lower	2,452,967.32
	<u>\$ 7,566,199.80</u>

Investments

Fixed Assets:

At reproduction cost less depreciation, as appraised by Ford, Bacon & Davis, Inc., as of June 30, 1926, adjusted to July 31, 1926—

Buildings and equipment	\$27,775,544.92
Less - Depreciation	<u>4,581,556.36</u>

	\$23,193,988.56
	<u>2,859,458.00</u>

Land and Mineral Reserves

Deferred Charges to future operations . .

	26,053,446.56
	<u>113,056.92</u>
	<u>\$33,852,803.28</u>

LIABILITIES

Current Liabilities:

Accounts payable	\$ 464,370.89
Accrued wages and other expenses	341,807.15
Reserve for Federal income taxes	<u>735,156.85</u>

\$ 1,541,334.89

Miscellaneous Reserves

63,766.11

First Mortgage (Sinking Fund 6% Gold Bonds, Series A, due September 15, 1941

13,000,000.00

Capital:

Series A Convertible 7% Cumulative Preferred Stock - 130,000 shares of \$100 each	\$13,000,000.00
Common Stock (no par value) 400,000 shares stated at	4,000,000.00
Surplus at organization	<u>2,247,702.28</u>

19,247,702.28

\$33,852,803.28

(See certificate on page 468.)

CERTIFICATE

We have examined the books and accounts of Clinchfield Portland Cement Corporation, Dexter Portland Cement Company (including Penn-Allen Cement Company prior to date of acquisition), Dixie Portland Cement Company and Pennsylvania Cement Company and their respective subsidiary companies for the three years and seven months ending July 31, 1926, and the plan and agreements providing for the issue by Pennsylvania-Dixie Cement Corporation (new corporation) of its bonds and capital stock for the assets subject to liabilities of the foregoing companies and for cash.

We certify that, in our opinion, the above balance sheet is correctly prepared so as to show the financial position of Pennsylvania-Dixie Cement Corporation, giving effect as at July 31, 1926, to the formation of the new company, to the provisions of the plan and agreements referred to and to the liquidation of certain liabilities of the predecessor companies incident to the financing.

We further certify that the combined earnings of the companies to be acquired, after deduction of depreciation and depletion as approved by Ford, Bacon & Davis, Inc., and adjustment in respect of special compensation and certain bonuses to be discontinued, and deduction of amounts equivalent to interest on \$13,000,000 Bonds, Federal income taxes at 13½% and dividend requirements on \$13,000,000 Preferred Stock, have been as follows:

Year Ending	Earnings as above
December 31, 1923	\$1,497,952.49
December 31, 1924	1,835,949.69
December 31, 1925	2,536,567.11
July 31, 1926	2,816,086.01

PRICE, WATERHOUSE & Co.

56 Pine Street, New York
September 18, 1926

Discuss the accounting and auditing principles and procedures involved in the above case. Is it possible to determine, in round amounts, where the proceeds of the 300,000 shares of no-par value common stock are reflected in the above balance sheet? ³

³ See articles by J. P. Friedman and Walter A. Staub in *The Journal of Accountancy*, Vol. XLIII (January, 1927), pp. 1-10 and 11-19, respectively. These papers given before the New York State Society of Certified Public Accountants are intended to cover the entire field of "Accounting Investigations for Refinancings, Consolidations, and Mergers."

PROBLEM 97

PIERCE PETROLEUM CORPORATION

Balance Sheets Giving Effect to Corporate Financing

The Pierce Petroleum Corporation was incorporated under the laws of Delaware on April 25, 1924, to "acquire the plants and other assets and assume the liabilities of the Pierce Oil Corporation"; for the above purpose the new corporation issued, under date of May 7, 1924, 1,103,679 shares of its no-par value capital stock to the old corporation. The losses of the Pierce Oil Corporation for the fiscal years ended December 31, 1921, 1922 and 1923 aggregated \$19,263,477.

It was also provided in the plan of reorganization that old stockholders might (a) subscribe for 1,300,000 shares of the new no-par value stock at \$7 per share, in the ratio of five shares of the new stock for each share of preferred stock in the old company, and one-half share of new stock for each share of common stock in the old company, and certain other subscription rights, and (b) exchange each one share of preferred stock and eight shares of common stock of the old company for approximately eight shares of the no-par value stock of the new company, plus a pro rata share of the dividends received by the old company upon the stock of the new company held in its treasury.¹

The accounts of the Pierce Oil Corporation and Subsidiary Companies were audited for the year ended December 31, 1923 by Messrs. Price, Waterhouse & Co., New York; on March 21, 1924 these accounts were certified "subject to the completion of the audit of the accounts of the refineries and distributing stations," and on March 24 (three days later) the consolidated balance sheet of the Pierce Petroleum Corporation (new company) as at December 31, 1923 but giving effect to the reorganization plan of March 24, 1924 was certified—the latter certificate also contained the above qualification included in the certificate of March 21, 1924. The consolidated balance sheet and profit and loss and deficit account of the Pierce Oil Corporation and subsidiary companies, as certified on March 21, 1924, follow:

¹ For details of the reorganization plan see Poor's & Moody's *Manual Consolidated*, 1924, Industrial Section, Vol. II, pp. 2062-2067.

PIERCE OIL
and Subsidiary
CONSOLIDATED BALANCE

ASSETS

Current and Working Assets:

Cash in banks and on hand	\$ 439,374.24
Notes and accounts receivable, less reserves . .	1,208,379.93
Inventories:	
Crude oil, refined products and merchandise	4,693,274.55
Warehouse materials for construction and operation	1,038,128.36
Interest, insurance, etc., prepaid	128,077.64

Working Assets:

Tank steamers and barges (after deducting \$1,223,- 365.14 to reduce to ap- praised value), ...	\$ 200,751.00	
Tank cars	2,029,902.44	
Stable and garage equipment	234,536.62	
Iron barrels and drums	302,432.28	
Drilling tools and equipment	87,184.47	2,854,806.81
Miscellaneous investments	51,920.13	\$10,413,961.66

Capital Assets:

Oil lands, leaseholds and development, pipe lines, etc. (including capital stock and advances to Compania Mexicana de Combustible, S. A., amounting to \$17,986,370.42)	\$22,669,451.00	
Real estate, buildings, plant and equipment at refineries and distributing stations	10,417,546.71	33,086,997.71

Total assets \$43,500,959.37

Deficit, as per accompanying statement 9,764,258.32

Notes: (a) At December 31, 1923, the company was contingently liable for \$772,046.11 in respect of customers' accounts receivable sold but uncollected at that date.

(b) Preferred stock dividends unpaid at December 31, 1923, amounted to \$2,400,000.

(c) Suits and claims for approximately \$725,000 have been filed against the company, but have not yet been adjudicated. No liability in respect thereof nor for possible further costs and claims arising out of the ousting of Directors in October, 1922, is included in the above balance sheet.

\$53,265,217.69

CORPORATION

Companies

SHEET, DECEMBER 31, 1923**LIABILITIES****Current Liabilities:**

Notes payable, secured:

By pledge of inventories of oil stocks and other assets	\$ 251,000.00
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By the pledge of the demand note of the Pierce Pipe Line Co., Inc., for \$3,073,876.13, payable to Pierce Oil Corporation and indorsed in blank; the validity of these notes and of this pledge is challenged by the corporation and suit has been instituted to cancel the notes, set aside the pledge and for an accounting	1,200,000.00
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Notes payable unsecured	766,565.35
-----------------------------------	------------

Trade acceptances	552,653.46
-----------------------------	------------

Accounts payable and accrued liabilities (including interest on Doherty notes and the account of the Empire Petroleum Co. which are being contested)	2,139,913.13	\$ 4,910,131.94
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Reserve for Contingencies, including provision in respect of a judgment entered February 28, 1923, in favor of International & Great Northern Railway Co., for \$2,088,483.40 with interest at 6% per annum, now on appeal under bond for \$2,225,000.00 secured by the pledge of inventories of oil stocks

2,032,254.31

Funded Debt:

Ten-year 8% sinking fund gold debenture bonds due December 15, 1931	\$ 2,000,000.00
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Less—Retired through sinking fund	300,000.00	1,700,000.00
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Note: At December 31, 1923, the company was in default of sinking fund requirements by an amount of \$100,000 which has since been made good.

Capital Stock:

Preferred stock 8% cumulative convertible:

Authorized and issued—150,000 shares of \$100 each	\$15,000,000.00
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Common stock:

Authorized—1,320,000 shares of \$25 each	\$33,000,000.00
--	-----------------

Issued—1,184,913.2575 shares of \$25 each	29,622,831.44
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Common stock Class "B":

Authorized—800,000 shares of \$25 each	\$20,000,000.00
--	-----------------

Held for conversion of preferred stock

\$15,000,000.00	
-----------------	--

Unissued	5,000,000.00	20,000,000.00
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44,622,831.44

 \$53,265,217.69

PIERCE OIL CORPORATION
and Subsidiary Companies
PROFIT AND LOSS AND DEFICIT ACCOUNT

For the Year Ending December 31, 1923

Gross Profit		\$6,076,618.47
Deduct - Marketing, general and administrative expenses		6,538,060.25
Balance		<u>\$ 461,441.78</u>
Deduct -		
Interest on funded and floating debt and com-		
mission to trustees and expenses under ac-		
ceptance loans	\$ 514,388.16	
Provision for uncollectible accounts receivable	95,290.01	
Provision for contingencies	212,425.20	
Provision for depletion and depreciation	<u>1,765,305.76</u>	
Total deductions		2,587,409.13
Net Loss for Period		<u>\$3,048,850.91</u>
Deficit as at December 31, 1922		4,417,619.22
Adjustments:		
Tank steamers and barges written down to appraised values	1,223,365.14	
Write down on Mexican bonds	80,999.00	
Book value of Texas City lots forfeited	16,998.13	
Profit arising on sale of Baker Oil lease	<u>67,551.81</u>	
		\$8,720,280.59
Balance of discount on capital stock, etc., shown separately at		
December 31, 1922, transferred to deficit account	1,043,977.73	
Total deficit at December 31, 1923, as per Balance Sheet		<u>\$9,764,258.32</u>

The foregoing statements were included in the Tenth Annual Report of the Pierce Oil Corporation to its stockholders; this report was dated March 20, 1924. The certificate of the auditors which accompanied the statements was as follows:

New York, March 21, 1924.

We have examined the books and accounts of the Pierce Oil Corporation and subsidiary companies in New York as at December 31, 1923, and have had produced to us the New York Office accounts relating to the refineries and distributing divisions and find that the attached balance sheet has been correctly prepared therefrom.

The Federal taxes of prior years have been provided for on the basis of the returns which were made as advised by counsel.

Subject to the completion of the audit of the accounts of the refineries and distributing stations and to the sufficiency of the reserves made in respect of oil lands and leases, we certify that, in our opinion, the attached balance sheet is correctly prepared so as to show the financial position as at December 31, 1923, and the relative income account is correct.

PRICE, WATERHOUSE & Co.

The consolidated balance sheet as at December 31, 1923 of the Pierce Petroleum Corporation and Subsidiary Companies, after "giving effect to the various corporate and financial changes brought about by the reorganization of the former company, including writing down of assets in amount of \$27,000,000 after supplying almost \$7,000,000 of new cash," and as certified on March 24, 1924, is shown on page 474.² The auditor's certificate was as follows:

We have examined the books and accounts of the Pierce Oil Corporation and subsidiary companies in New York as at December 31, 1923, and have had produced to us the New York office accounts relating to the refineries and distributing divisions. We have also examined the agreement and plan of March 24, 1924, providing for the formation of the new company and the sale of the capital stock of the new company in part for the assets, subject to the liabilities, of the Pierce Oil Corporation, and in part for cash (the amount of such cash being taken at the minimum to be received under the agreement and plan). The reserve item of \$2,550,000 for claims in litigation and for Federal taxes is based upon the opinion of counsel as to the probable adequacy of such reserve and we certify that, subject to the completion of the audit of the accounts of the refineries and distributing stations, the foregoing balance sheet, in our opinion, is correctly prepared so as to show the financial position of the new company as at December 31, 1923, giving effect as at that date to the transactions above mentioned and the application of the new cash in part to the reduction of notes and accounts payable.

PRICE, WATERHOUSE & Co.

56 Pine Street, New York,
March 24, 1924

In July, 1924 the banking house of Lehman Brothers, 16 William Street, New York, assisted by Goldman, Sachs & Co. and Hornblower & Weeks, offered to the public 1,348,500 shares of the no-par-value stock of the Pierce Petroleum Corporation; this represented the balance of the total authorization of 2,500,000 shares of the new corporation. The stock was offered for subscription at \$7 per share; the prospectus stated that the offering was made "if, when and as issued and accepted by us, subject to the approval of counsel. It is expected that delivery of stock will be made on or about July 24, 1924, at the office of Lehman

² The quotation included in the above sentence was part of a letter dated November 28, 1928 from Mr. William H. Coverdale, chairman of the board of the Pierce Petroleum Corporation, to the author. The reader will be interested in checking these figures to the balance sheets certified on March 21 and March 24, 1924.

PIERCE PETROLEUM CORPORATION (NEW COMPANY)

and Subsidiary Companies

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1923

Giving effect as at that date to (a) the provisions of the agreement and plan of March 24, 1924, providing for the formation of the new company and the sale of the capital stock of the new company in part for the assets, subject to the liabilities, of the Pierce Oil Corporation, and in part for cash (the amount of such cash being taken at the minimum to be received under the agreement and plan) and (b) the application of the new cash in part to the reduction of notes and accounts payable.

ASSETS

Current and Working Assets:

Cash	\$5,181,808.89
Notes and accounts receivable, less reserves	1,209,093.36
Inventories:	
Crude oil, refined products and merchandise	4,693,274.55
Warehouse materials for construction and operation	1,038,128.36
	<u>\$12,122,305.36</u>

Note: If all the stockholders of the old company exercise the rights to be given them pursuant to the agreement, to subscribe to the stock of the new company, the cash and also the capital and initial surplus will be increased by \$975,000.

Capital Assets:

Real estate, buildings, plant and equipment at refineries and distributing stations	\$9,942,452.06
Pipe lines	1,510,866.93
Tank cars	2,029,902.44
Tank steamers and barges	200,751.00
Stable and garage equipment	234,536.62
Iron barrels and drums	302,432.28
Drilling tools and equipment	50,000.00
	<u>14,270,941.33</u>

Note: No valuation has been included in this balance sheet in respect of the company's oil lands and leaseholds in the United States and Mexico.

Deferred Charges:

Prepaid interest, insurance, etc.	128,077.64
	<u>\$26,521,324.33</u>

LIABILITIES

Current Liabilities:

Accounts payable and accrued liabilities	\$ 420,012.99
Trade acceptances	552,653.46
	<u>\$ 972,666.45</u>

Reserves:

For International & Great Northern Ry. Co. judgment of \$2,088,483.40 plus interest, now on appeal under bond of \$2,225,000, secured by the pledge of inventories of oil \$2,200,000.00

For Doherty notes and claims in litigation, for Federal taxes of prior years and for contingencies including other pending litigation 2,550,000.00

Funded Debt:

Ten-year 8% sinking fund gold debenture bonds due 1931	\$2,000,000.00
Less—Retired through sinking fund	300,000.00
	<u>1,700,000.00</u>

Note: Additional debentures of a par value of \$100,000 were retired through the sinking fund on February 14, 1924

Capital and Initial Surplus:

Net assets—Represented by 2,500,000 shares of no par value	19,098,657.88
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Note: At December 31, 1923 the company was contingently liable for \$772,046.11 in respect of customers' accounts receivable sold but uncollected, all of which, however, are considered good.

\$26,521,324.33

Brothers, 16 William Street, New York, N. Y., in the form of temporary stock certificates, against payment therefor in New York funds." The prospectus also stated that "it is expected that application will be made to list this stock on the New York, Boston and Chicago Stock Exchanges."

Included in prospectus was also a consolidated balance sheet as at December 31, 1923 of the Pierce Petroleum Corporation and subsidiary companies, after giving effect to the contemplated financing; this balance sheet was certified on June 25, 1924, and, except for changes in three items in the statement, was the same as that certified on March 24, 1924.³ In the certificate attached to this balance sheet the auditors specifically state that "we have now completed the examination of the accounts of the Pierce Oil Corporation and subsidiary companies as at December 31, 1923"; the letter of the chairman of the board of the corporation to the bankers who underwrote the stock, together with the balance sheet certified to give effect to the financing, are as follows:

PIERCE PETROLEUM CORPORATION
111 Broadway, New York

Messrs. Lehman Brothers,
Goldman, Sachs & Co., and
Hornblower & Weeks,
New York, N. Y.

July 3, 1924.

Gentlemen:

Complying with your request for information pertaining to the business, properties, and organization of Pierce Petroleum Corporation, which has acquired the plants and other assets and assumed the liabilities of Pierce Oil Corporation, please be advised as follows:

The predecessor companies of Pierce Petroleum Corporation have been engaged in the business of refining, transporting and marketing petroleum products since 1857, during which time they have been important factors in the oil industry. Until very recent years the predecessor

³ The three items which changed between the two dates of certification were Cash, Reserves, and Capital and Initial Surplus. In the statement certified on March 24, 1924 a note appears with reference to the additional amount which would be received if all stockholders of the old company exercise their rights to subscribe to the stock of the new company; by comparing the cash items in the two balance sheets it would appear that only \$35,861.25 additional cash was received from such stockholders—the cash account was depleted for the \$1,550,000 payment to settle the judgment in favor of the receiver of the International & Great Northern Railway Co. The difference between these two amounts accounts for the decrease in cash in the balance sheet certified on June 25, 1924. The \$2,200,000 reserve to provide for the above judgment has disappeared from the second statement, while the net worth in the balance sheet certified June 25, 1924 has increased \$685,861.25 (\$35,861.25 plus \$650,000).

company did a large and profitable business which in 1919 amounted to gross sales of \$35,334,642 from which a net profit was derived of \$2,751,884 according to the audit of that year of Messrs. Price, Waterhouse & Co.; but during the last three years it suffered severe losses due in large part to causes other than those normally arising from the conduct of its business. These causes have been largely eliminated and the business is again enjoying substantial net earnings which will be greatly increased by the plant improvements, the economies of operation, and the restoration of sound credit which will follow the new financing.

Under the present plan of refinancing the business by the sale of non-interest bearing securities entailing no fixed charge, the entire floating debt is to be paid off, adequate provision is made for contingent liabilities, ample working capital is furnished to insure good credit, and a carefully considered improvement and betterment program in amount of \$2,000,000 is included—the benefit of which program in the opinion of the management and of independent consulting engineers will be very substantial. The result of the financing will be to relieve the business of costly and burdensome interest and operating charges and to leave as the only fixed charge the interest and sinking fund on \$1,500,000 debentures due in 1931; to promptly put two of the Corporation's most important refineries in competitive operating condition and a third in serviceable condition; to greatly improve marketing facilities; and to enable the Corporation to conduct in an economic and efficient manner its business of refining and marketing oil and its products in Southwestern United States and in Mexico.

The attached Balance Sheet of the new Corporation, certified by Messrs. Price, Waterhouse & Co., gives effect to the new financing. Briefly, this plan of financing provides for the purchase by Pierce Petroleum Corporation of the assets and business of Pierce Oil Corporation for 1,103,678 shares of the former's no-par-value stock out of a total of 2,500,000 shares, and for the assumption of the latter's outstanding debt. The remaining shares of new stock have been sold to stockholders of the old company and to the Syndicate of which you are the Managers. The Balance Sheet giving effect as at December 31, 1923, to the financing and the transactions in connection therewith, shows:

Net Current Assets after all reserves . . .	\$ 7,085,500.00
Property Account, less depreciation	14,270,941.00
Net Assets applicable to capital and surplus after all deductions	19,784,519.00

From which it appears that as at December 31, 1923, the net current assets amounted to \$2.83 for each share of the new stock, and the net assets amounted to \$7.91 per share.

These figures value fixed assets on a conservative basis and ascribe no value whatsoever to oil lands and leases in the United States or Mexico because of the difficulty in appraising such properties at the present time and until their true value has been more fully demonstrated; they show

inventory at cost or market whichever is lower and provide a reserve for all known contingent liabilities.

During the first five months of 1924 substantial improvement has occurred in the Corporation's credit position. The net income for this period, after interest on debentures now outstanding, after reserves for bad debts and after adequate depreciation (but before interest on current indebtedness, which indebtedness will be provided for through this financing), has amounted to \$295,000 which is at the rate of \$708,000 per annum (before Federal taxes) without allowing for the increased consumption of the Corporation's products during the summer months.

In addition to the above net income which is being earned under existing poor plant and credit conditions the Corporation will enjoy a substantial return on its new expenditures for modernizing and balancing its plant and equipment, which improvements should be completed early in 1925; and will also be able to effect large savings in operations due to a thorough reorganization of its manufacturing, sales and general office staff, and to its re-established credit.

During the first year of operating, after the improvements have been completed, the Corporation should earn, in the judgment of its management, confirmed by the reports of independent engineers as to the effects of the improvements, a total net income after interest, depreciation and taxes of at least \$2,500,000, all of which would be available for corporate purposes. A large part of this additional income is expected to be derived from the operation of new pressure stills and other improvements at refineries and from the enlargement of marketing facilities.

The Corporation owns five refineries, four of which, those located at Sand Springs, Texas City, Fort Worth and Tampico, have an aggregate capacity in their present condition of 30,000 barrels of crude per day. The fifth refinery, located at Vera Cruz, represents a nominal investment on the books of the Company. The refineries at Sand Springs and Tampico are practically in full operation; that at Texas City is in partial operation; while that at Fort Worth is not operating. The Corporation also owns a compounding plant at St. Louis; pipe lines serving the Sand Springs and Fort Worth refineries; over 1600 tank cars; and steel storage capacity at refineries in the United States for about 2,900,000 barrels.

The marketing of the Corporation's products is accomplished through 818 distributing stations, of which 756 are located in the United States and the balance in Mexico. The Corporation supplies a substantial percentage of the market demand for petroleum products in the territory served by it in the States of Missouri, Illinois, Arkansas, Louisiana, Oklahoma, Texas and in the Republic of Mexico; and such market demand is rapidly increasing.

With the contemplated improvements to its refineries and marketing facilities, with adequate working capital, with a thoroughly reorganized

and enthusiastic operating staff, and with relief from the burdensome conditions of debt and litigation which have contributed so largely to the disappointing showing of the last three years, Pierce Petroleum Corporation faces a future of great promise and of enhanced commercial success.

The new management is acquiring a substantial amount of the new stock which you are about to offer to the public, thus expressing their confidence in the inherent soundness of the business.

It is expected that application will be made to list the stock of the Pierce Petroleum Corporation on the New York, Boston and Chicago Stock Exchanges.

Yours very truly,
WILLIAM H. COVERDALE,
Chairman of the Board

The financing balance sheet accompanying the prospectus is shown on page 479, while the accountants' certificate which was appended to it was as follows:

Referring to our previous certificate of March 24, 1924, we have now completed the examination of the accounts of the Pierce Oil Corporation and subsidiary companies as at December 31, 1923. We have also examined the agreement and plan of March 24, 1924, providing for the formation of the new company and the sale of the capital stock of the new company in part for the assets, subject to the liabilities, of the Pierce Oil Corporation, and in part for cash. The reserve item of \$2,550,000 for claims in litigation and for Federal taxes is based upon the opinion of counsel as to the probable adequacy of such reserve, and we certify that the foregoing balance sheet, in our opinion, is correctly prepared so as to show the financial position of the new company as at December 31, 1923, giving effect as at that date to the transactions above mentioned and the application of the new cash in part to the reduction of notes and accounts payable and to the contract to settle for \$1,550,000 the judgment in favor of the Receiver of the International & Great Northern Railway Co., and also giving effect to the release of the inventories of oil pledged thereunder.

PRICE, WATERHOUSE & Co.

56 Pine Street, New York,
June 25, 1924.

Study the statements of the Pierce Oil Corporation and of its successor, the Pierce Petroleum Corporation, and discuss the changes which have occurred in the successive balance sheets. Note the content of the certificates of audit; from the standpoint of the prospective investor do these statements and the certificates attached thereto give the information desired? Do these

PIERCE PETROLEUM CORPORATION
(NEW COMPANY)
and Subsidiary Companies

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1923

Giving effect as at that date to (a) the provisions of the agreement and plan of March 24, 1924, providing for the formation of the new company and the sale of the capital stock of the new company in part for the assets, subject to the liabilities, of the Pierce Oil Corporation, and in part for cash and (b) the application of the new cash in part to the reduction of notes and accounts payable and to the contract to settle for \$1,550,000, the judgment in favor of the Receiver of the International & Great Northern Railway Co.

Current and Working Assets:

Cash	\$3,667,670.14
Notes and accounts receivable, less reserves	1,209,093.56
Inventories:	
Crude oil, refined products and merchandise	4,693,274.55
Warehouse materials for construction and operation	1,038,128.36
	\$10,608,166.61

Capital Assets:

Real estate, buildings, plant and equipment at refineries and distributing stations	\$9,942,452.06
Pipe lines	1,510,866.93
Tank cars	2,029,902.44
Tank steamers and barges	200,751.00
Stable and garage equipment	234,536.62
Iron barrels and drums	302,432.28
Drilling tools and equipment	50,000.00
	14,270,941.33

Note: No valuation has been included in this balance sheet in respect of the company's oil lands and leaseholds in the United States and Mexico.

Deferred Charges:

Prepaid interest, insurance, etc.	128,077.64
	\$25,007,185.58

LIABILITIES

Current Liabilities:	
Accounts payable and accrued liabilities	\$ 420,012.99
Trade acceptances	552,653.46
	\$ 972,666.45

Reserves:

For Doherty notes and claims in litigation, for Federal taxes of prior years and for contingencies, including other pending litigation

2,550,000.00

Funded Debt:

Ten-year 8% sinking fund gold debenture bonds due 1931 (Pierce Oil Corporation) \$2,000,000.00
Less—Retired through sinking fund 300,000.00

1,700,000.00

Note: Additional debentures of a par value of \$200,000 have been retired through the sinking fund since December 31, 1923.

Capital and Initial Surplus:

Net assets—Represented by 2,500,000 shares of no par value 19,784,519.13

Note: At December 31, 1923, the company was contingently liable for \$772,046.11 in respect of customers' accounts receivable sold but uncollected, all of which, however, are considered good.

\$25,007,185.58

balance sheets and certificates meet the requirements which the American Institute of Accountants has prescribed for such statements? Discuss.

PROBLEM 98

THE CITY OF X

Accounting Advice: Opinion on Cost of Operating Water Works

The City of X, a well-known prosperous city of 70,000 people located on the Pacific Coast, owns and operates its own water works. A recent balance sheet of this department of the city showed an investment in fixed plant of \$612,500, of which approximately \$475,000 was ten years of age or older. The total assets amounted to \$800,000 and were represented by bonds amounting to \$525,000, by current accounts and bills payable, etc., of \$160,000, and by the city's equity in the water department of \$115,000.

Recently certain questions arose regarding the items which might properly be included in the cost of producing water; the Mayor of the City of X telegraphed Messrs. Wright and Dickinson, Certified Public Accountants, San Francisco, as follows:

The City of X owns its own Water Works, which is a revenue-producing department. The charter provides that all revenue-producing departments should be placed on a self-sustaining basis. No depreciation, replacement charges, interest on bonds, or redemption of bonds has been charged as an expense item against the water works. If these items were charged against the water works the department would run at a loss. I believe that interest, and either depreciation or the redemption of bonds should be charged as an expense against the city water works. The bonds are forty-year bonds.

Heretofore the various city departments using water, such as the fire department, park department, etc., have not been charged for the water used. The spirit of the charter is that revenue-producing departments should merely support themselves, with no thought of making a profit. My belief is that the various departments mentioned above should be charged at actual cost for the amount of water used by them, and that the balance needed to operate the water works should be raised by a water

charge at cost equitably levied according to the amount of water used individually. The charter prohibits water meters.

Your criticism of my stand on the above two questions will be of considerable assistance in helping us solve our problem.

Alton E. Davis, Mayor

Prepare the statement which you believe Messrs. Wright and Dickinson would be justified in submitting to Mayor Davis; this should be prepared either as a letter, or as a telegram similar in form to the above.¹

PROBLEM 99

WRIGHT SAVINGS BANK

Accounting Advice: Valuing the Capital Stock of Banks

Part I

In the town of Ringgold, California, a community of about 4,500 people, are five banks. For several months negotiations had been in progress between the First National Bank and the Wright Savings Bank to consolidate the two institutions, in order that they might better meet the competition of the other banks, all of which were branches of large San Francisco institutions. The directors and stockholders of both institutions were sincere in their desire to bring the two banks together; the officers of both banks agreed that on the basis on which they desire to consolidate a bonus or premium must be paid by the First National Bank to the Wright Savings Bank. The point on which they could not agree was the amount of the bonus.

The First National Bank had capital stock of \$50,000, surplus of \$15,000 and undivided profits of \$4,500, deposits of \$450,000, and loans and discounts of \$275,000. The Wright Savings Bank had \$20,000 of capital stock, \$20,000 of surplus and \$4,800 of undivided profits, \$750,000 of deposits, and \$575,000 of loans and discounts. Under the new capital set-up it was the intention to have a capital stock of \$75,000 and a paid-in surplus of \$15,000. The present stockholders of the First National Bank

¹ See Hatfield, *Accounting*, p. 341; Jackson, "Some Problems in Depreciation," *Journal of Accountancy*, Vol. XXXI (February, 1921), pp. 81-102.

desired to receive \$50,000 of this capital stock; the stockholders of the Wright Savings Bank had agreed to accept the other \$25,000 of the new capital stock, providing sufficient bonus is paid them.¹ Each bank was to distribute as a special dividend to its stockholders its net worth in excess of the amount of the initial proprietorship which its present stockholders would have in the new institution.

There was to be a joint meeting of the directors of the two banks on Thursday, March 31, 1927, at 2:00 P.M. At 10:00 A.M. on Wednesday, March 30, the president of the Wright Savings Bank called J. L. Simons, a Certified Public Accountant of California, on the telephone and asked him to value the stocks of the two institutions and to make a report thereon in time for the directors' meeting of the following day. The banks desired that he take into consideration the earnings of both institutions during the past ten-year period.

Mr. Simons agreed to undertake the work; how should he have proceeded?

Part II

When Mr. Simons arrived at the Wright Savings Bank he was met by D. C. Parsons, president of the bank, who gave him approximately the information set forth in Part I of the problem. Mr. Parsons stated that during June, 1926, while he and the president of the First National Bank were on a business trip east, this consolidation had been discussed with a vice-president of their large eastern correspondent, and they had been informed that a fair value for their respective capital stocks would be the net book worth of the banks, plus 3% of their respective deposits.² The banks had not been able, however, to get together on this basis of valuation and had accordingly asked Mr. Simons to assist in determining their fair value.

¹ That is, under the new organization the present stockholders of the First National Bank would have a two-thirds interest in the consolidated bank, and the present stockholders of the Wright Savings Bank would have a one-third interest.

² It is a common practice in valuing banks to compute a bank's goodwill as a certain per cent on its deposits; this percentage will vary, depending upon general business conditions and the location of the bank, etc., from 3% to 7%, and in unusual cases even more. The amount so computed is considered the fair premium to be paid on the bank's capital stock, over and above the net book value of the stock.

Mr. Parsons further informed Mr. Simons that it was the desire of both institutions that he add back annual losses on bad accounts, and such other items as he believed would be necessary to make the earnings of the two banks comparable.³ The banks believed that these additional items included officers' salaries, and possibly rent and depreciation. Mr. Simons suggested that since it was the custom in many banks to charge expenditures for equipment, and similar capital items, to earnings, it might be well also to add back all capital expenditures charged to revenue. To this Mr. Parsons agreed.

Mr. Simons then stated that because of the very brief time at his disposal, and also because the information would be in comparable form,⁴ he had decided that he would base his study on the federal income tax returns which the two institutions had filed during the past ten-year period. He emphasized that he would not be able to make any verification of the accounts, but must necessarily accept the figures as given in the accounting records at his disposal. With this preliminary discussion, Mr. Simons began the actual compilation of the figures needed for his study.

Mr. Parsons brought to Mr. Simons the federal income tax returns of the Wright Savings Bank for the ten preceding years, together with the annual statements of the bank for those years, and the general ledger. Mr. Simons decided that he had only approximately two and one-half hours to give to the Wright Savings Bank, and accordingly prepared from the income tax returns the schedule shown on page 484.

Although Mr. Simons did not really expect to have need for all of the material included in this schedule, he thought it best to take record of it in order to have available such information as he would need for his report. He discussed briefly with Mr. Parsons the ten-year averages shown by his working schedule, and then proceeded to the First National Bank.

At the First National Bank Mr. Simons was met by the president, H. C. Lancaster, who discussed with him briefly the problem which confronted the two banks, and then asked him what

³ See Montgomery, *Auditing Theory and Practice*, 4th rev. ed., pp. 500-504.

⁴ Since one bank was organized under federal law, and the other state law, and the reports submitted to the respective governmental authorities were not uniform, the federal income tax returns represented the best materials available which were usable for a quick survey of this kind.

WRIGHT SAVINGS BANK
REVIEW OF EARNINGS, 1917 TO 1926, INCLUSIVE

Year	Net Earnings	Losses on Bad Paper	Salaries of Officers	Rent	Depre. on Furniture and Fixtures	Capital Items Charged to Expense	Dividends Paid	
							%	Amount
1917	\$ 4,830.96	\$ 817.46	\$ 4,000.00	\$ 400.00	\$ 320.00	\$ 643.86	12	\$ 2,400.00
1918	5,617.82	923.66	4,200.00	450.00	320.00	733.18	16	3,200.00
1919	7,864.99	785.83	4,800.00	600.00	400.00	804.34	24	4,800.00
1920	4,565.13	1,765.44	5,400.00	600.00	400.00	312.10	12	2,400.00
1921	3,811.26	3,981.97	6,000.00	600.00	400.00	616.27	12	2,400.00
1922	1,783.45	6,411.29	6,000.00	600.00	400.00	412.66	4	800.00
1923	2,168.90	5,543.70	7,200.00	600.00	400.00	529.03	8	1,600.00
1924	3,573.07	4,619.38	7,200.00	600.00	400.00	783.62	12	2,400.00
1925	2,219.73	5,396.55	8,000.00	600.00	400.00	486.45	12	2,400.00
1926	3,533.09	3,473.40	8,400.00	600.00	400.00	558.09	13	2,600.00
Totals	\$39,968.40	\$33,718.68	\$61,200.00	\$5,650.00	\$3,840.00	\$5,879.60		\$25,000.00
Average	3,997.00	3,372.00	6,120.00	565.00	384.00	588.00	12½	2,500.00

books and records he would like for his examination. Mr. Simons explained that on account of the short time which he had at his disposal he had decided to base his study upon the federal income tax returns of the two banks; accordingly he asked that these be given him. Mr. Lancaster stated that he believed the annual statements of the bank to the United States government officials would be a better basis for his study, and suggested that Mr. Simons use these instead of the income tax returns. Mr. Simons replied that the statements submitted annually by the two banks to the state and federal authorities, respectively, were not wholly comparable, whereas the federal income tax returns were readily comparable. Mr. Lancaster thereupon furnished Mr. Simons with copies of his bank's income tax returns for the years 1917 to 1926, inclusive; he also produced copies of the statements which the bank had filed with the federal authorities for those years, and left Mr. Simons to his work. Mr. Simons, after scrutinizing the several statements and returns, prepared the schedule shown on page 486—in form it was the same as the schedule he had already prepared for the Wright Savings Bank.

Upon the completion of the preceding working schedule, Mr. Simons discussed the averages briefly with Mr. Lancaster; he questioned the accuracy of the charges for losses on bad paper for 1925 and 1926, but was assured by the president that the bank had been unusually careful during those years in extending credit and in making loans, and had been very richly rewarded by the rather ultra-conservative policy which had been adopted. The real estate, Mr. Lancaster stated, was carried in the books at cost; the bank did not care to encumber its accounts with depreciation charges either on the building, or on the small amount of furniture and fixtures which had been capitalized in the books. The bank considered, furthermore, that any depreciation on the building was more than offset by the continually increasing value of the real estate. During the past ten years the bank had followed the policy of charging all capital expenditures immediately to revenue accounts.

As a result of his brief survey, Mr. Simons decided to make no adjustments in the earnings of the two institutions, except to add back in each case the losses on bad paper. It was true that the average salaries of officers were larger in the case of the

FIRST NATIONAL BANK
REVIEW OF EARNINGS, 1917 TO 1926, INCLUSIVE

Year	Net Earnings	Losses on Bad Paper	Salaries of Officers	Rent (taxes and estimated maint.)	Depre. on Furniture and Fixtures	Capital Items Charged to Expense	Dividends Paid	
							%	Amount
1917	\$ 6,507.95	\$ 565.00	\$ 6,000.00	\$ 181.40	None	\$ 117.64	8	\$ 4,000.00
1918	7,211.23	483.50	6,040.00	178.54	"	226.80	12	6,000.00
1919	10,261.46	816.74	6,250.00	201.36	"	115.00	16	8,000.00
1920	5,736.89	1,200.95	6,250.00	205.49	"	2,212.65	12	6,000.00
1921	5,069.37	2,873.22	6,250.00	262.93	"	145.99	10	5,000.00
1922	1,983.65	4,941.87	6,250.00	208.24	"	205.81	8	4,000.00
1923	3,085.44	4,173.39	6,500.00	235.66	"	65.00	6	3,000.00
1924	4,948.73	3,157.58	6,500.00	240.17	"	175.50	6	3,000.00
1925	4,121.15	460.73	6,600.00	212.48	"	201.74	6	3,000.00
1926	4,781.06	728.31	6,750.00	223.37	"	135.13	8	4,000.00
Totals	\$53,706.93	\$19,401.29	\$63,390.00	\$2,149.64	None	\$3,601.26	9.2	\$46,000.00
Average	5,370.00	1,940.00	6,339.00	215.00	None	360.00		4,600.00

First National Bank, while the rent, depreciation, and capital expenditures charged directly to expense amounted to more in the case of the Wright Savings Bank. For the aggregate of these four items the average expenditures of the Wright Savings Bank for the ten-year period exceeded those of the First National Bank by approximately \$600; it must be recognized, however, that these expenses are bound to vary somewhat in different institutions—similarly, since the Wright Savings Bank had a larger amount of loans and discounts it would be expected that it would have a larger average loss from bad debts than would the First National Bank. Since all the loss from bad paper was to be added back to earnings, Mr. Simons believed that this \$600 would somewhat equalize the larger expected losses of the Wright Savings Bank from uncollectible paper. In arriving at an amount of earnings, therefore, which he should capitalize, he decided to make no changes in the net earnings because of these various items of expense.

Was the procedure adopted by Mr. Simons satisfactory for the purposes of this study? What value should he assign to the capital stock? Outline briefly what he should include in his report to Mr. Parsons and Mr. Lancaster.

Part III

Upon completing his work at the First National Bank, as set forth in Part II of the problem, Mr. Simons took the schedules to his own office to prepare his report to Mr. Parsons and Mr. Lancaster, the presidents of the two banks. As has been stated previously, he had already come to the conclusion that he would make no adjustment in the earnings of the period because of any differences in the salaries of officers, rent, depreciation, and capital items charged to expense currently; he recognized that such adjustment might be made, but he considered that as a practical business matter a fairer picture of the worth of the respective institutions would be obtained without it. He felt personally that it worked to the advantage of the Wright Savings Bank to add back to net earnings all of the losses on bad debts; bad debts are bound to occur even under the very best management, and

it is reasonable to expect that the amount of the loss would be somewhat proportionate to the volume of the loans and discounts. Accordingly, any advantage which the First National Bank might have from not adding back the several accounts named would be balanced by the advantage accruing to the Wright Savings Bank from adding back all losses for the period from bad accounts.

Mr. Simons also felt that capitalization of earnings solely was a questionable basis for valuing the stocks of the banks; even though capitalized earnings is frequently the sole basis for valuation, Mr. Simons decided to use an average of several bases in determining the value of the capital stocks. These computations are set forth in his report, as follows:

J. L. SIMONS

Certified Public Accountant

Ringgold, California,
March 31, 1927.

Mr. H. C. Lancaster, President,
First National Bank,
Ringgold, California.

Mr. D. C. Parsons, President,
Wright Savings Bank,
Ringgold, California.

Gentlemen:

Pursuant to instructions received I have made a general survey of the earnings of the First National Bank and of the Wright Savings Bank for the ten-year period, January 1, 1917 to December 31, 1926, to determine the value of the capital stocks of the two institutions. Because of the limited time at my disposal, the study has been based upon the Federal income tax returns and upon other reports prepared by your institutions; no verification has been made of any figures submitted, all amounts being accepted as given.

In addition to the net earnings as shown by your books, certain other items, which might have an important effect on the valuation of the capital stocks, have been considered. The most important of these is the item, Losses on Bad Paper; in accordance with your instructions the total amounts of such losses have been added back to the net earnings in order to show what the institutions are really presumed to be capable of earning.

Other items considered were Rent, Salaries of Officers, Depreciation, and Capital Items Charged to Expense; the latter item refers especially to amounts for furniture and fixtures charged at once to expense. The reason for considering these last four items was to make sure that both

institutions were making approximately equal charges for them; otherwise the net earnings would not give a true picture of the comparative strength of the two banks. The total dividends paid were also noted as a matter of general interest.

The results of the study may be summarized as follows:

Average for Ten-Year Period

<u>Item</u>	<u>First National Bank</u>	<u>Wright Savings Bank</u>
Net Earnings	\$5,370.00	\$3,997.00
Losses on Bad Paper	1,940.00	3,372.00
Salaries of Officers	6,339.00	6,120.00
Rent (in case of First National Bank, taxes and estimated maintenance)	215.00	565.00
Depreciation on furniture and equipment	None	384.00
Capital items charged to Expense	360.00	588.00
Dividends paid	4,600.00	2,500.00
Average rate of dividends	9.2%	12.5%

It will be observed that for the ten-year period the salaries of officers have been greater in the case of the First National Bank, whereas the rent item has been somewhat greater for the Wright Savings Bank; the two items taken together, however, are approximately equal. Therefore, no adjustment has been made in the net earnings of either bank because of officers' salaries or rent. In the case of depreciation and of capital items charged to expense, the Wright Savings Bank average exceeds that of the First National Bank by approximately \$600.00; it must be recognized, however, that these expenses will vary somewhat in different institutions, and I have not added this \$600.00 back to the net earnings of the Wright Savings Bank in arriving at the amount to capitalize.

Although the losses on bad paper averaged considerably larger in the case of the Wright Savings Bank, it is probable that the percentage was not any larger, if as large, as in the case of the First National Bank. Based upon the loans and discounts of the two institutions as of December 31, 1926, the average loss on bad paper was 5.86% in the case of the Wright Savings Bank as against 7.05% for the First National Bank. In accordance with your wishes the entire amount of such losses has been added back to the net earnings of the respective institutions to show what they are capable of earning. This gives a figure to capitalize of \$7,310.00 in the case of the First National Bank, and of \$7,369.00 in the case of the Wright Savings Bank.

I have considered that in the case of these banks 10% is a fair basis of capitalization; whatever rate is used comparable figures would be obtained. If, therefore, we use the 10% basis (and express all results in even hundreds of dollars only) a value for the capital stocks is obtained, as follows:

First National Bank	\$73,100.00
Wright Savings Bank	\$73,700.00

Usually, however, such a valuation would not be based entirely on earnings; even when averaged for a ten-year period some consideration would be given to the invested capital, which at December 31, 1926, was approximately \$69,500.00 for the First National Bank and \$44,800.00 for the Wright Savings Bank. Frequently, in such case, the net assets are given a weighting of 1 and capitalized earnings a weighting of 2; if this method of valuing the capital stocks were used, the results would be:

First National Bank	\$71,900.00
Wright Savings Bank	\$64,000.00

You have already, I understand, determined a valuation based upon the sum of the capital stock, surplus and undivided profits, and 3% on the deposits, of the respective institutions. This gave a valuation, according to the computations made, of approximately \$83,000.00 for the First National Bank, and of \$67,300.00 for the Wright Savings Bank. These several valuations may be summarized as follows:

<u>Basis of Valuation</u>	<u>First National Bank</u>	<u>Wright Savings Bank</u>
Average adjusted earnings for ten-year period capitalized at 10%	\$73,100.00	\$73,700.00
Average adjusted earnings capitalized (as above) and net assets, weighted	71,900.00	64,000.00
Capital stock, surplus and undivided profits, and 3% on deposits	83,000.00	67,300.00
Capital stock, surplus, and undivided profits (net assets)	69,500.00	44,800.00
Arithmetical average of above four methods	74,375.00	62,450.00

From the above it will be seen that the earnings of the Wright Savings Bank have a considerably greater value than do those of the First National Bank. Because of the larger deposits of the Wright Savings Bank, and of their potential and actual earning power, these deposits must be considered in determining a fair value for the respective capital stocks. Inasmuch as so many factors enter into the valuation of the capital stock of a business, and since practically all of these factors are given greater or less consideration in some of the various bases of valuation used, it is believed that the arithmetical average of the four bases shown gives a reasonably fair valuation for your respective capital stocks.⁵

⁵ According to information obtained by the author, Mr. Simons used this averaging method of finding the value of these capital stocks because he believed that it most nearly took into consideration all factors involved; he stated that he was not aware that just this method had ever been used before. It is all the more interesting, therefore, that approximately the same method is used by Gerstenberg in his *Financial Organization and Management* (see pp. 544-552); on p. 551 a comparative summary of six different methods of distributing stock to the various participants in a consolidation is given, together with an average of all the methods shown.

Upon this basis of valuation I believe you will be able to bring your two institutions into the proposed consolidation with satisfaction to all concerned, and with real benefit to your community.

In conclusion, I desire again to remind you that slight errors may exist in the figures used, but I do not believe these are sufficient to change materially the results obtained. I am submitting herewith a copy of my work-sheet for your own institution; from this you will be able readily to ascertain how I obtained the figures presented for your bank. Exactly similar methods were used for each bank, and the same sources of information were made available to me.

I desire to thank you for the cooperation and assistance given; I shall be glad, upon request, to be of any further assistance possible.

Yours very truly,
(Signed) J. L. SIMONS

Mr. Simons delivered copies of the above report at noon, Thursday, March 31, to Mr. Lancaster and Mr. Parsons. The report was discussed at the two o'clock meeting of the directors, and Mr. Parsons was instructed by the two boards to ask Mr. Simons to make a computation of the bonus which the First National Bank should pay to the Wright Savings Bank. This computation was to be made on the basis of the new bank having a net worth of \$90,000 (\$75,000 of capital stock, plus \$15,000 of paid-in surplus) at the date of its organization, two-thirds of which would be owned by the present stockholders of the First National Bank and one-third by those of the Wright Savings Bank. The total net worth of the present institutions, above the required \$60,000 and \$30,000 respectively which they should put into the consolidation, was to be distributed as a special dividend to the present stockholders of the two banks.

The directors of the Wright Savings Bank believed that this bonus should be approximately \$15,000, while those of the First National Bank maintained that the maximum bonus should not exceed \$6,000.

Criticize constructively the report of Mr. Simons and the valuations which he assigned to the capital stocks of the two banks; also, determine what the bonus should be on the basis of Mr. Simons' computations.

Part IV

Upon adjournment of the meeting of the combined boards of directors (Part III), Mr. Parsons of the Wright Savings Bank requested Mr. Simons to make a computation of the amount of the bonus which he believed should be paid by the First National Bank to the Wright Savings Bank. It has already been stated that the consolidation plan provided that the two institutions should withdraw \$9,500 and \$14,800, respectively, plus additional earnings since December 31, 1926, thus making the proprietorship of the new institution \$90,000—that is, \$75,000 of capital stock, and \$15,000 of paid-in surplus. Of this total proprietorship the present stockholders of the First National Bank would have \$60,000 (500 shares of capital stock of a par value of \$100 each) and those of the Wright Savings Bank would have \$30,000 (250 shares of the capital stock). Mr. Simons had pointed out to Mr. Parsons the danger, from the standpoint of the stockholders of his own bank, of going into a consolidation where, because they were minority stockholders, they might lose complete control of the greater assets of their institution; Mr. Parsons stated that he had no fear from this source, inasmuch as all of the stockholders of both banks were neighbors of long standing and very good friends. All stockholders were local business men.

Mr. Simons thereupon proceeded to compute the bonus. He used as the basis of his computation the arithmetical average of the four methods of valuation given in his report of March 31; it was necessary, he believed, to adjust this to give effect to the withdrawal of earnings as set forth above. His computations were as follows:

<u>Basis of Valuation</u>	<u>First National Bank</u>	<u>Wrights Savings Bank</u>
No. 1	\$ 73,100.00	\$ 73,700.00
No. 2	68,700.00	59,100.00
No. 3	73,500.00	52,500.00
No. 4	60,000.00	30,000.00
Totals	<u>\$275,300.00</u>	<u>\$215,300.00</u>
Average of above four methods	\$ 68,800.00	\$ 53,800.00
Sum of above two averages	\$122,600.00	
First National Bank's share is:	68,800.00 ÷ 122,600.00 = 56.12%	
	56.12% of \$90,000.00 = \$50,508.00	

This \$50,508 is the amount of the net worth of the new institution which the First National Bank should have, based upon the value of the stocks of the two banks (adjusted to give effect to the withdrawal of earnings as already set forth).

However, the present stockholders of the First National Bank desire to own \$60,000 of the new net worth (\$50,000 of capital stock, plus \$10,000 of paid-in surplus); accordingly these stockholders must pay a bonus of approximately \$9,500 (\$60,000 less \$50,508 equals \$9,492) to the present stockholders of the Wright Savings Bank.

Mr. Simons saw both Mr. Parsons and Mr. Lancaster, explained the basis on which he had made his computations, and stated that he believed a bonus of \$9,500 would be a fair amount to pay to the Wright Savings Bank stockholders. Called meetings of both boards of directors were held, and Mr. Simons explained to each why he believed \$9,500 would be a fair bonus. The board of directors of the Wright Savings Bank decided that even though the bonus was not as large as they believed their stockholders should have, concessions would probably have to be made by both sides if the two banks were ever to unite; furthermore, Mr. Simons had been called in as a disinterested expert, and on the basis of comparable figures from the two institutions had arrived at \$9,500 as a fair bonus to be paid—the board voted, therefore, to accept this figure as a basis for the consolidation. The board of directors of the First National Bank merely took the matter under advisement, but made no expression of its attitude on the recommendation of Mr. Simons.

In case the consolidation went through it had been agreed to call the new institution the Wright National Bank.

Discuss the methods employed by Mr. Simons throughout this assignment; do you agree with the valuations determined by him, and the amount of bonus to be paid by the First National Bank? If not, what amount of bonus do you believe should be paid? Discuss.

APPENDIX

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I. The Auditor and His Work

PROBLEM 1

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II. Legal Status and Liabilities of Auditors

PROBLEMS 2 AND 3

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